CLAYTON HOLDINGS INC
Form 10-K
March 14, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2007

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: 000-51846

CLAYTON HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**20-2660764** (I.R.S. Employer Identification No.)
2 Corporate Drive **Shelton, Connecticut** (Address of principal executive offices)	**06484** (Zip Code)

(203) 926-5600
(Registrant's telephone number, including area code)

[None]
(Former name, former address and former fiscal year, if changed since last report)

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

Title of each Class	Name of each exchange on which registered
Common Stock, $0.01 Par Value Per Share	The Nasdaq Global Market

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 ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No ý

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 ý 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. ý

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

Large accelerated filer o	Accelerated filer ý	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of June 29, 2007, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was $137,195,329 (based on the closing price for the registrant's common stock on the Nasdaq Global Market of $11.39 per share). At February 29, 2008, 22,128,980 shares of the registrant's common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The registrant intends to file a proxy statement pursuant to Regulation 14A within 120 days of the end of the fiscal year ended December 31, 2007. Portions of such proxy statement are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

Item 1. Business

Certain statements in this Annual Report on Form 10-K are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These statements involve a number of risks, uncertainties and other factors that could cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by these forward-looking statements. Factors which could materially affect such forward-looking statements can be found in the section entitled "Risk Factors" in Part 1, Item 1A. in this Annual Report on Form 10-K. Investors are urged to consider these factors carefully in evaluating the forward-looking statements and are cautioned not to place undue reliance on such forward-looking statements. The forward-looking statements made herein are only made as of the date hereof and we will undertake no obligation to publicly update such forward-looking statements to reflect subsequent events or circumstances.

References in this Annual Report on Form 10-K to "Clayton," the "Company," "we," "us" or "our" are to Clayton Holdings, Inc., a Delaware corporation, and its subsidiaries.

Overview

We provide a full suite of outsourced services, mortgage-related analytics and specialized consulting services for buyers and sellers of, and investors in, mortgage-related loans and securitizations. Our services include:

- transaction management, which consists of due diligence, professional staffing services, compliance products and services, consulting and conduit support services;
- oversight and reporting on mortgage-backed securities (credit risk management and surveillance); and
- specialized loan servicing services (special servicing), and consulting services.

We use proprietary technology and processes to provide these services throughout the full life cycle of a loan, from loan origination, aggregation and securitization to the surveillance and administration of loans and securities.

We provide a majority of our services to participants in the non-agency mortgage-backed securities, or MBS, market and the non-conforming mortgage loan market. We have long-standing client relationships with many of the leading capital markets firms, banks and lending institutions, including the largest MBS issuers/dealers, mortgage and bond insurance companies and fixed income investors. We believe that we are a leading provider of these services to our clients due to our many years of experience, our deep knowledge of the industry and our database of non-conforming loan transactions. During 2007, we performed detailed analyses on approximately 448,000 loans totaling approximately $100 billion in principal value, which represented approximately 9% of the total principal balance of U.S. non-conforming mortgage loan originations over such period. As of December 31, 2007, we were monitoring approximately $454 billion in loans underlying MBS.

Conforming residential mortgage loans are loans that adhere to the underwriting guidelines of the government sponsored entities, or GSEs, such as the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). Non-conforming residential mortgage loans are loans that do not meet the underwriting guidelines of the GSEs, typically because of one or a combination of the following: loan size, borrower credit profile, loan to value ratio, documentation or type of loan.

MBS issued by GSEs are referred to as agency MBS, and have historically comprised a majority of the residential MBS that have been issued. A large segment of the MBS market includes private-label, or non-agency, issuers such as capital markets firms and banks.

We generate the majority of our revenue from the services we provide to support the large non-agency MBS and non-conforming mortgage loan markets. In 2007, the aggregate principal value of new issuances of non-agency MBS was $707 billion, up from $136 billion in 2000, although the 2007 total was down significantly from $1,146 billion in 2006. The principal balance of non-conforming mortgage loan originations was $1,168 billion in 2007, up from $390 billion in 2000, although the 2007 total was down significantly from $1,910 billion in 2006. Securitization rates for non-conforming mortgage loans have increased from 34.6% in 2000 to 57.9% in 2007; however, the 2007 rate was down slightly from 58.8% in 2006. We believe the volume of non-agency MBS securitizations and non-conforming mortgage loan originations will be significantly lower in 2008 than in 2007. With recovery in the mortgage markets, we believe that several factors support the demand for our services over the long term, including:

- investors' growing demand for transparency, independent validation of data and third-party oversight of loans collateralizing MBS;
- the desire for outsourced services by capital markets firms and other major mortgage loan market participants, and,
- the increased complexities and requirements of federal, state and local regulations applicable to the mortgage loan industry.

Our revenue is also driven by non-agency MBS issuance and the aggregate number of non-conforming mortgage loan originations. Changes in the volume of non-agency MBS issuances and non-conforming mortgage loan originations impacts the number of loans for which we perform our services, leading to a corresponding change in gross revenue.

The volume of non-agency MBS securitizations declined by 38% and non-conforming mortgage loan originations declined by 39% in 2007 as compared to 2006. The markets deteriorated throughout 2007, with non-agency MBS issuance declining by 81% and non-conforming loan originations declining by 69% in the fourth quarter as compared to the comparable period in 2006. In 2007, the non-conforming mortgage sector was characterized by turmoil and deteriorating conditions including the withdrawal of credit by warehouse credit lenders, bankruptcy of multiple industry participants, tightening of underwriting standards, increased mortgage delinquencies and defaults by borrowers, reduced origination volumes, downgrades by credit rating agencies, decreasing liquidity in the secondary mortgage market and reductions in personnel, among others. In addition, nearly all industry participants project that the volume of non-agency MBS securitizations and non-conforming mortgage loan originations will be lower in 2008 than 2007. In response to the current environment, we are optimizing our organizational structure by reducing operating costs, including a reduction in the number of employees and the closure of certain operating locations. Should the market continue to deteriorate and result in significantly decreased revenues, additional reductions to our operating costs could result. We do believe the non-agency MBS securitizations and non-conforming mortgage loan markets will rebound from the volumes experienced in the fourth quarter of 2007; however, the timing and magnitude of this recovery is uncertain. While we expect these conditions may impact our earnings in the near term, we believe that the challenges facing the industry could ultimately benefit us. We believe there will be continued demand for new loan products and increased home ownership driven in part by first-time homeowners. In addition, we believe MBS investors and regulators will seek additional transparency, independence and disclosure relating to data provided on the loans collateralizing MBSs, which could increase demand for our services over the long term.

Our Service Offerings

Our services, as depicted in the following diagram, support the principal stages in the life cycle of a mortgage loan.

Transaction Management

Transaction management services have historically constituted a majority of our business. We provide a full range of outsourced transaction management services to our clients, including due diligence, compliance products and services, conduit support services and professional staffing services. We combine our extensive knowledge of, and experience in, loan origination, servicing, securitization and project management with an approach tailored to our clients' needs. Through our consulting business we advise clients on issues related to business process improvement, risk management, regulatory compliance, and technology enablement. For the years ended December 31, 2007, 2006 and 2005, transaction management revenue accounted for 63.6%, 79.4% and 83.6%, respectively, of total revenue.

Due Diligence Services

Our due diligence services primarily help loan buyers and sellers make decisions on how they price portfolios and manage risk. Historically, our clients select a sample of loans for us to review from a pool they are considering for purchase and we consult with our clients to customize the scope of each due diligence assignment based on factors such as the client's history and experience with the seller, the size and experience of the seller, the representations and warranties to be provided to the buyer, the type of loan and the quality of the data. We provide our services through our internal proprietary systems including the Clayton Loan Analysis System, or CLAS, our High Cost Analyzer, or HCA, our pool of independent loan review specialists and our employees. We provide due diligence services primarily on residential loans, and to a lesser extent on non-residential and consumer loans.

The following summary describes several key services available in a representative transaction involving due diligence on residential loans, which constitute a majority of the loans we review:

Data Integrity: We verify and enhance data presented to us by the seller. We accomplish this through the use of electronic checks and edits, manual data integrity checks and data comparison.

Credit Underwriting: Aided by CLAS, we review and assess the credit quality of each loan by re-underwriting it to the seller's origination guidelines and/or buyer's credit guidelines. We assign preliminary credit event grades of 1, 2 or 3 (which denote, respectively, whether the loan is within benchmark guidelines, outside of the guidelines but should be considered for purchase based upon compensating factors, or outside of the guidelines and should be rejected) to each loan and in many cases, subsequently reconcile the differences, if any, between the buyer and the seller.

Regulatory Compliance: We review loans for regulatory compliance using the proprietary compliance module of our CLAS system. This module, which incorporates relevant laws and regulations and is monitored by our internal compliance specialists and periodically reviewed by our external legal counsel, filters loan data against relevant federal, state and local high cost and predatory lending regulations (including the Home Ownership and Equity Protection Act and Truth in Lending Act) for the presence of material exceptions. The module then renders a decision and assigns a preliminary compliance event grade indicating whether the loans are compliant, need additional review due to lack of evidentiary documentation or contain a compliance exception to be addressed. After reconciliation, we assign final compliance event grades to the loans and deliver the results to the buyer.

Fraud: We have developed a fraud review methodology that combines our proprietary process with vendor-based fraud detection solutions. We can also integrate the results from a loan buyer's preferred fraud detection vendor into our system. Our review process includes a verification of borrower identity, residence, employment, property and closing procedures. We also perform a legal document review of the note, mortgage, riders, title and mortgage insurance details. We review loans for possible fraud and flag those indicating characteristics requiring further evaluation. The flagged loans are thoroughly researched and the results are reported to the buyer (and if the buyer permits, the seller). If items can be cured, the relevant loans are marked for purchase by the buyer. Items which remain open are reported to the buyer for further evaluation.

Property Valuations: In addition to providing various property valuation management services, we also use third-party valuation providers and internal resources to revalue or perform an additional review of the property. Our objective is to assess and enhance the level of confidence in property values. We report to the buyer those loans with collateral value variances outside of pre-determined tolerance levels.

Presently, the majority of our due diligence services are conducted at our centralized underwriting facility in Tampa, Florida. Due diligence services are also conducted on site at loan sellers' facilities by our independent loan review specialists. Our centralized underwriting facility in Tampa, Florida, replicates the capabilities of an on-site due diligence team, while limiting related travel costs. We are increasingly utilizing our centralized underwriting facilities to perform our services, which should reduce the amount of per-loan travel expenses. Clients may ship loan files electronically or by conventional mail delivery to these facilities. The centralized underwriting facility provides us and our clients with significant cost savings, and we expect to continue to shift a greater volume of due diligence services to centralized underwriting operations in the future.

Conduit Support Services

Our conduit support services provide the technology and systems required to manage key aspects of a buyer's loan acquisition pipeline, including overall process management, due diligence, fulfillment, funding and integration with third-party service providers. Typically, conduits act as the financial intermediary between loan originators and investors. We provide our clients with a flexible processing platform which can be readily modified to support their purchase of individual mortgage loans and small and mid-size mortgage pools from a variety of originators, regardless of volume. We do not expect to generate material revenues from conduit support services in 2008.

Professional Staffing Services

Through our staffing services, clients obtain access to qualified, independent mortgage loan professionals to augment their staffs on both a long- and short-term basis. Clients can utilize these mortgage loan professionals to manage special projects and satisfy cyclical or unforeseen demand, while reducing human resource cost and risk. We typically provide these services to our clients as part of an existing or potentially broader relationship.

Compliance Products

We provide our proprietary compliance testing engine through the High Cost Analyzer suite, or HCA, to market participants including loan originators. HCA is an on-line tool that is used to verify that loans comply with certain predatory lending regulations at the federal, state and local levels. Our team of compliance specialists regularly update HCA and it is reviewed periodically by external legal counsel. HCA's unique filtering approach can test and identify all loans for additional detailed analysis, as necessary, to ensure compliance with new or changing predatory lending regulations. Originators have begun to test for loan compliance as a safeguard against originating a loan that will not be funded due to non-compliance and to mitigate the potential decreased value of selling a non-compliant loan into the secondary market.

Consulting Services and Independent Pricing Services (IPS)

Through our consulting business we advise clients on issues related to business process improvement, risk management, regulatory compliance, and technology enablement. IPS provides services to certain investor clients to assist them in estimating the value of illiquid mortgage securities.

Surveillance and Special Servicing

Our surveillance and special servicing businesses extend our services beyond the origination process to the later stages in the life of a loan, including ongoing monitoring and management of loans in the securitization process. These services also provide performance data which we believe, when linked to data collected in our up-front transaction management services, will allow our clients to more effectively assess risk at the point of underwriting/origination.

Credit Risk Management and Surveillance

Through Clayton Fixed Income Services we provide credit risk management and surveillance services to MBS underwriters, issuers, services and investors. These services consist of oversight and reporting on predominantly residential non-agency MBS. These credit risk management and surveillance services are typically contract-based for the remaining life of the security. Frequently, our efforts result in cash recoveries and uncover costly systemic errors for our clients.

Our credit risk management activities are centered on seven core processes, and may include any of the following:

Data Verification. We conduct an initial review and verification of key mortgage loan data provided by servicers or other third parties.

Loan-level Surveillance. Our analysts utilize a proprietary risk-filtering technology to identify loans that present a higher degree of risk to the performance of the transactions. For example, our technology searches for loans with significant declines in value, indications of fraud, lengthy foreclosure timelines and loans with characteristics that do not fit the applicable criteria of the securitization. Such loans receive increased oversight that proactively mitigates securitization losses.

Loan Repurchases (Putback Reviews). We identify loans that may be subject to repurchase or replacement as a result of a failure to meet the applicable securitization criteria and such loans may be repurchased or replaced by the seller. We also facilitate the repurchase process in certain instances.

Loss Analysis. We scrutinize losses in the portfolio searching for miscellaneous processing errors, such as duplicate fees, high escrow advances, overstated legal fees and questionable broker fees.

Prepayment Premium Analysis. Frequently, the securitizations that we monitor contain loans with prepayment penalties. We monitor the loans that have been paid in full to ensure that any applicable penalties are collected and remitted properly.

Mortgage Insurance Analysis. Many loans within the securitizations that we monitor have mortgage insurance. We oversee these loans to ensure that coverage is accurate, claims are filed and processed in a timely manner and proceeds are collected and remitted properly.

Remittance Reconciliation. We review each cash remittance to ensure that it reconciles with the monthly loan-level data.

One of our signature services is the Clayton Fixed Income Services "Value Add" notification, which we send to clients to notify them of situations in which we have uncovered errors resulting in potential savings to the MBS investor.

We also evaluate servicers for operational quality using our proprietary benchmarking methodology that gauges a servicer's operational quality relative to its servicing volume and its industry peers. We regularly consult with servicers to help them improve their operations and enhance the overall performance of the pools of loans they service and the corresponding MBS.

For the years ended December 31, 2007, 2006 and 2005, surveillance revenue accounted for 29.6%, 15.0% and 12.2%, respectively, of total revenue.

Special Servicing

Our special servicing activities facilitate the management and disposition of sub-performing and non-performing loans. Sub-performing and non-performing loans are typically classified as loans where the borrower/obligor is over 30 days delinquent, and include loans for which the lienholder may, in the future, take possession through foreclosure proceedings. We believe that this service is countercyclical to our origination focused services, as economic conditions which typically have a negative impact on origination volume also tend to lead to rising delinquencies and defaults.

Our services include comprehensive loan management for defaulted and delinquent loans, collection management and oversight, loss mitigation, foreclosure and bankruptcy administration, eviction and real estate owned (REO) disposition oversight. We use our proprietary Mortgage Asset

Recovery System, or MARS, to assess risk and value enhancement alternatives, and to identify optimal asset disposition methods.

For the years ended December 31, 2007, 2006 and 2005, special servicing revenue accounted for 6.8%, 5.6% and 4.2%, respectively, of total revenue.

Competitive Strengths

We believe that we have developed a strong reputation among our clients and that we have the following competitive strengths:

Long-term Relationships with Industry Participants. We provide our services to the leading buyers and sellers of, and investors in, residential and commercial loan portfolios and securities. Our clients include major capital markets firms, banks and lending institutions, including the largest MBS issuers/dealers, mortgage and bond insurance companies and fixed income investors and the GSEs. During 2007, 2006 and 2005, we worked with each of the 10 largest non-agency MBS underwriters, as ranked by *Inside MBS & ABS,* which accounted for 70%, 73% and 73% of total underwriting volume during those respective periods.

Deep Market Expertise, Experienced Professionals and Proprietary Technology. As a pioneer in providing outsourced mortgage loan-related services to institutional participants in the mortgage industry, we have developed considerable industry experience and a large database of loan information. We believe that we were the first significant service provider in the industry to build a technology platform to refine the due diligence process from a primarily manual process to a highly automated, computer-driven review. Our highly trained and experienced professionals assist clients across all stages of the loan life cycle, and can access our experience, process and data, which we refer to as our intellectual capital, from thousands of historical transactions to strengthen their recommendations and analysis.

Comprehensive Suite of Outsourced Services and Mortgage-Related Analytics. We provide a comprehensive suite of outsourced services, mortgage-related analytics and specialized consulting services to the mortgage loan and MBS industries. Our services and information support the life cycle of a loan from origination through maturity, with data and analytics aggregated and utilized by us and our clients. Our services combine our core expertise in transaction management and due diligence and our sophisticated technology.

Scalable and Flexible Operating Model. We operate a highly scalable and flexible operating model based on a proprietary technology platform, large database of mortgage loan information and a flexible, mobile workforce of experienced, qualified and trained independent loan review specialists. We have invested significant time and money developing our technology platform, which is capable of analyzing high volumes of data and generating accurate information and reports for our clients. With a substantial database of information already amassed and an advanced technology platform in place, we believe we are well-positioned to profitably grow our business.

Critical Position at the Nexus of Loan Buyers, Sellers and Investors. Our comprehensive suite of outsourced services, industry experience, large database of loan information, numerous and long-standing relationships with leading capital market participants and strong reputation have positioned us at the nexus of mortgage loan portfolio buyers, sellers and investors. Through the services we provide, we perform necessary functions across the life cycle of a loan and effectively act as a facilitator for the loan buyer and investor communities.

Through the combination of our due diligence and surveillance business units, we have begun to link loan origination data with ongoing loan performance data to enable more sophisticated data aggregation, dynamic reporting capabilities and advanced loan analytics. This seamless delivery of a broad spectrum of centralized services and information that supports the life cycle of a loan helps our clients make better buying decisions.

Clients

Since 1990, our clients have included many of the leading capital markets firms, banks and lending institutions, mortgage and bond insurance companies, MBS issuers/dealers, conduits and fixed income investors.

For the year ended December 31, 2007, no single client represented greater than 10% of our revenues.

For the year ended December 31, 2006, revenue from our largest two clients, Deutsche Bank and Morgan Stanley, accounted for an aggregate of 24.4% of our total revenue. Each of these clients accounted for more than 10% of our total revenue.

Segment Information

Note 18, Segment Information, to the Consolidated Financial Statements provides financial information about our segments.

Financial Information about Geographic Areas

We have no material foreign operations.

Information Technology

Proprietary Technology

We use proprietary technology to improve quality and productivity, facilitate client interaction, organize knowledge and capture the full value of data collected. Our technology is supported by a network infrastructure that is designed to securely handle large amounts of data. Our proprietary technology applications include:

Clayton Loan Analysis System, CLAS Conduit and CLAS Reporting Tool. Our due diligence process utilizes the CLAS application. CLAS collects data and verifies it for accuracy during the on-site and centralized underwriting loan file review process. Additionally, CLAS accommodates all mortgage loan and other asset types and is a customizable application that gathers appropriate data depending on the scope of the project. CLAS verifies and tests the reasonableness and accuracy of all captured data. The system also has the ability to produce reports that identify emerging trends, while providing a real-time overview of asset quality. During the first quarter of 2008, the Company began a process to enhance and upgrade the CLAS application.

High Cost Analyzer (HCA). HCA is a web-based application derived from CLAS that helps market participants identify loans that exceed certain federal, state and local predatory lending thresholds. Our experienced compliance professionals monitor changes in laws and regulations and update HCA accordingly. In addition, HCA is integrated with a leading on-line publisher of reference information and forms for the residential mortgage lending industry. This integration provides direct access to applicable predatory lending legislation and streamlines the research process for compliance professionals.

Clayton.com. Clayton.com facilitates data conversion, analysis and electronic due diligence. Clayton.com is our portal through which clients, employees and our independent loan review specialists access reports and communicate with each other on transactions they are managing. Our conduit support services also use clayton.com to provide information to loan buyers and sellers as to the status of the loan acquisition process.

Mortgage Asset Recovery System. MARS is a proprietary servicing platform that assesses risk and value enhancement alternatives and identifies the optimal asset disposition methods for both performing and non-performing loans.

Clayton Fixed Income Services Report Archive. Report Archive is a secure web-based application used by our clients to download prior and current Credit Risk Manager reports for individual securitizations.

Technology Infrastructure

Our technology infrastructure is comprised of networks, data centers and multiple independent local area networks located in Shelton, Connecticut; Tampa, Florida; Denver, Colorado; and Costa Mesa, California. Our business applications run on both shared and dedicated platforms, and when necessary, are accessible from each of our operating locations. These interlinked networks and data centers increase system availability in the event of an unplanned business interruption.

Our architecture accommodates high volumes of transactions and load balance processing across multiple servers, assuring availability in the event of a single component hardware or system failure. By utilizing clustering and load balancing technologies, each web, application and database tier can scale horizontally as transactional volume increases over time.

Our primary data center is located in Shelton, Connecticut. Our application, network and voice infrastructure are housed in a secure, environmentally controlled data center with 24-hour system monitoring and threshold alerting. Access to the facilities is controlled through the use of individually issued magnetic access security cards. We use proprietary network security architecture with procedural requirements for network address translation, port filtering and redirection. We employ a redundant firewall infrastructure for layered network traffic management. In the event of power failure, our data center is protected by uninterruptible power supply battery backup and a natural gas power generator. We also utilize redundant telecommunications lines to ensure high availability for our voice and data networks. We maintain physical, electronic and procedural safeguards to store and secure client information from unauthorized access and use, alteration and destruction. Our own policies and procedures have been developed to protect the confidentiality of client information and to comply with relevant rules and regulations, while meeting our clients' service requirements.

Intellectual Property

We rely on copyright and trade secret law to protect our technology. Additionally, we have developed a number of brands that have accumulated substantial recognition in the marketplace, and we rely on trademark law to protect our rights in that area. We intend to continue our policy of taking all measures we deem necessary to protect our copyright, trade secret and trademark rights. We regard our internally-developed software as proprietary and utilize a combination of copyright, trade secret laws, internal security practices and employee non-disclosure agreements for intellectual property protection. We believe that we hold all proprietary rights necessary to conduct our business.

In 2001, CFIS filed two patent applications (each with multiple claims) related to data filtering technology. The first patent relates to analyzing investment data in a manner that provides a single comprehensive tool for filtering a loan pool to identify characteristics of the loan pool and the loans in the pool. The second patent relates to an invention that provides methods useful for the surveillance of loan pools and investing in loan pools, including a method for generating a loss list, for estimating a loss for a loan, and for determining a probability of loss for a loan. These two patent applications are pending.

In 2004, CFIS filed a provisional patent application related to its Question Portal, a secure, internet-accessible site that enables us to communicate directly with parties to a securitization (including servicers, master servicers, and insurance companies). The Question Portal technology enables instant communication, tracks all questions and responses and provides a variety of analytics on the types of issues, aging of issues and response times of our and a service provider's personnel. In 2005, we filed a non-provisional patent application for the Question Portal. The application is pending.

Competition

The market for our services is highly fragmented, highly competitive and rapidly changing. We compete with several providers of due diligence services and other providers focused on technology products, staffing services, portfolio management, credit risk management and surveillance services. Although several organizations compete with us across multiple business lines, we believe no firm competes with us across all of the service offerings that we provide. We believe the following are the principal factors by which providers of information-based analytics and knowledge-based services to the MBS market compete for business:

- quality and depth of underlying databases;
- breadth of services offered;
- client service and support;
- proprietary nature of methodologies, databases and technical platform;
- recognition as industry leader and developer of the industry standard;
- level of brand recognition and credibility as a participant in the secondary market; and
- performance track record for services provided on transactions executed.

Government Regulation

Our business is subject to certain federal, state and local laws and regulations. In particular, our subsidiaries that provide mortgage loan servicing services are subject to licensure as a mortgage loan servicer and collection agency in certain states. As a licensee, these subsidiaries must comply with certain state laws, including state collection laws. In addition, these subsidiaries are subject to certain other federal, state and local laws and regulations, including Regulation AB, the Real Estate and Settlement Procedures Act and Regulation X, the Equal Credit Opportunity Act and Regulation B, the Fair Housing Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Title V of the Gramm-Leach-Bliley Act of 1999, and state privacy and data security laws.

Employees and Independent Loan Review Specialists

As of December 31, 2007, we employed 413 persons on a full-time basis. In addition, during 2007, we used the services of approximately 1,400 independent loan review specialists and other qualified independent mortgage loan professionals to perform transaction due diligence and other services for our clients. None of our employees or independent loan review specialists is represented by a union or is covered by a collective bargaining agreement. We believe that our relations with our employees and independent loan review specialists are satisfactory. A majority of our independent loan review specialists are employed by a professional employee organization and assigned to us upon our request. The independent loan review specialists then undergo our thorough training program. The professional employee organization assumes responsibility for all payroll, benefits and workers compensation obligations in connection with the independent loan review specialists. Our agreement with the professional employee organization expires on January 1, 2009, after which it may be terminated by either party, with or without cause, with 60 days prior written notice. Our agreement with the professional employee organization provides us with staffing flexibility and a greater ability to manage labor and overhead costs. At December 31, 2007, our contractor pool totaled approximately 500 individuals.

Available Information

Our Internet address is *http://www.clayton.com*. We make available, free of charge, on or through our Website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements on Form DEF 14A and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. The information on our Website is not part of this Annual Report on Form 10-K for the year ended December 31, 2007.

Item 1A. Risk Factors

Set forth below are certain risk factors that could harm our business, results of operations and financial condition. You should carefully read the following risk factors, together with the financial statements, related notes and other information contained in this Annual Report on Form 10-K. This Annual Report on Form 10-K contains forward-looking statements that contain risks and uncertainties. Please refer to the discussion of "Forward-Looking Statements" on page two of this Annual Report on Form 10-K in connection with your consideration of the risk factors and other important factors that may affect future results described below.

Risks Related to Our Business and Industry

The non-agency MBS market, to which we provide our services, suffered a dramatic downturn during the second half of 2007 and we do not expect this market to undergo any meaningful recovery during 2008.

Our ability to generate revenue from our transaction management services has historically been closely linked to the volume of new securitizations of non-agency MBS. As a result of increased incidences of delinquencies, early payment defaults, first payment defaults and fraud, the value of previously issued non-agency MBS, and in particular subprime MBS, dramatically decreased during the second half of 2007. As a result, investors reduced investments in new non-agency MBS. The total volume of new securitizations of non-agency MBS during the fourth quarter 2006 was $276 billion as compared to $53 billion during the fourth quarter 2007. As a result, revenue in our core due diligence operations decreased from $33.3 million during the fourth quarter 2006 to $5.0 million during the fourth quarter 2007, a decrease of 85%. We do not expect that the non-agency MBS issuance market will undergo any meaningful recovery during 2008. A sustained downturn of the non-agency MBS issuance market will have an adverse impact on our transaction management services business and, consequently, our results of operations during 2008.

Adverse changes in the MBS market, particularly in the non-agency or non-conforming sector, the mortgage lending industry or the housing market have resulted, and will continue to result, in a reduced demand for our services.

Our business is driven in part by the non-agency MBS market, the mortgage lending industry and the housing market, each of which is highly sensitive to trends in the general economy, including availability of credit, interest rates, economic conditions, taxation policies, employment levels, stringency of underwriting guidelines and wage and salary levels. Adverse changes in any of these trends, the continued downturn in the non-prime mortgage loan market, including the failure of additional non-prime lenders, the discontinued use of additional non-prime mortgage products, or a decline in the sale of both new and existing homes or in home values, will lessen the demand for mortgage loans, which will result in a reduced demand for our services and diminish our revenues. A material reduction in the number of loans available for securitization has caused, and may continue to cause, our clients to engage us for fewer services, which has had, and will continue to have, an adverse effect on our business and results of operations.

Our profitability is affected by fluctuations in the volume of activity in the non-prime mortgage lending market.

A large portion of our revenue is generated by various services performed for buyers of, or investors in, non-prime mortgages. In 2007 and to date, many non-prime mortgage companies have encountered financial difficulties as a result of increased incidences of delinquencies, early payment defaults, first payment defaults and fraud. As a result, many buyers of, and investors in, non-prime mortgages have adjusted their investment allocations away from non-prime MBS. The remaining buyers of, and investors in, non-prime mortgages have been demanding a higher risk premium for their investment and insisting that non-prime lenders tighten their underwriting standards. These developments have, and will likely continue to, increase the cost of capital for non-prime lenders and inhibit their ability to sell their products. Additionally, many lenders have discontinued offering non-prime mortgage products, including such products as the 2/28 adjustable rate mortgage. Borrowers that historically would have purchased this mortgage product may now purchase a mortgage that does not adjust until five years or more, thus delaying one of the factors that leads to refinancing of non-prime mortgages.

As a result of the above factors, the number of non-prime mortgages that are being originated has been significantly reduced. This, in turn, has reduced the volume of non-prime loans that are being securitized by our customers. Securitization volumes are also affected by other factors including the relative demands for such loans and mortgage-backed securities evidencing interests in such loans, the cost of credit enhancements, investor perceptions of such loans and mortgage-backed securities, and the risks posed by such products. A sustained reduction in the volume of securitizations of non-prime mortgages has caused, and will continue to cause, our clients to engage us for substantially fewer services than they have historically. This reduction for demand in our services has had, and will continue to have, an adverse effect on our business and results of operations.

The impact of the investigations into the subprime mortgage industry cannot be predicted and may have a material adverse effect on our customers, customer relationships, business, results of operations and financial condition.

The Attorney General of the State of New York (the "NY Attorney General") is conducting an industry-wide investigation into mortgage fraud in both the primary and secondary markets. In connection with this investigation, in June 2007, we received a subpoena from the NY Attorney General seeking information and documents relating to the transaction management services that we provided to our clients. We have been cooperating with this investigation, including providing to the NY Attorney General due diligence reports on various pools of loans that we had reviewed for our clients. We have agreed to continue to cooperate with this investigation and, if requested, provide testimony regarding the same. In exchange for our continued cooperation, Clayton, its officers, directors, employees and agents were granted immunity from civil and criminal prosecution by the State of New York.

We have also received a voluntary information request from the Securities and Exchange Commission ("SEC"), and information subpoenas from the Attorney General of the State of Connecticut and the Attorney General of the Commonwealth of Massachusetts. Although we have no reason to believe we are the target of investigations by the SEC and other governmental or regulatory agencies, the agreement with the NY Attorney General does not provide immunity from prosecution by anyone outside the State of New York.

Responding to subpoenas and requests for information is costly and may divert management's time and efforts away from our operations. We cannot predict the effect that investigations by the NY Attorney General, the SEC or other governmental or regulatory agencies, will have on the mortgage industry generally and, in particular, the non-agency segment of the subprime mortgage industry, our business, our customers, or our customer relationships, although our agreement to cooperate with the

NY Attorney General, negative publicity, fines, sanctions, penalties, legal fees or increased regulations could have a material adverse effect on our customers, customer relationships, business, results of operations and financial condition.

Accelerated prepayments of loans that comprise the MBSs for which we provide credit risk management and surveillance services may adversely affect our results of operations.

Because we are compensated for providing credit risk management and surveillance services based on the level of assets under surveillance, prepayments of the loans that comprise the MBSs under surveillance decrease our revenues. Historically, prepayments accelerate when interest rates decrease and existing loans are refinanced, when new loan programs are introduced or when larger percentages of loans are moving into foreclosure proceedings. Interest rates have been reduced, federal and state agencies are proposing new loan programs and foreclosure rates in many jurisdictions are at high and rising levels. Should prepayments accelerate faster than we project, we may experience an adverse effect on our revenues and results of operations.

Increasing the amounts of mortgage loans and the size of individual loans the Government Sponsored Enterprises ("GSEs"), may buy or securitize and the expansion of Federal Housing Administration ("FHA") loan programs, may reduce the number of non-agency mortgage loans and consequently the size of the market to which we provide our services.

Recently, the Office of Federal Housing Oversight increased the amounts of mortgage loans the GSEs are allowed to hold in their portfolios and the Economic Stimulus Act of 2008 increased, through December 31, 2008, the size of individual loans the GSEs are permitted to buy or securitize. These changes enable the GSEs to purchase mortgage loans that are currently made on a non-agency basis, effectively shrinking the size of the non-agency mortgage market. If the GSEs use this expanded authority or if these changes are extended or made permanent, our clients may reduce their involvement in the market for non-agency loans, resulting in a reduction in securitization activity and demand for our services. Similarly, expanding role of the FHA to include issuing mortgages to borrowers who were previously candidates for subprime mortgages may also decrease the demand for non-agency mortgages and may result in a reduction in securitization activity and demand for our services. While we do provide services to the GSEs, we may not be able to maintain or increase the amount of services we provide to the GSEs, in amounts satisfactory to offset the decline in services provided to other clients.

Higher rates of loss in pools of loans that we service could result in lower demand for our services and damage to our reputation as a loan servicer.

We are in the business of servicing non-performing mortgage loans. If we experience higher-than-expected levels of loss severity in pools of loans that we service, the demand for our services may be reduced, which would result in a loss of future servicing income and may damage our reputation as a loan servicer and may impair our ability to attract new clients.

A sustained downturn in the residential mortgage loan origination business will adversely affect our business and harm our operations.

The residential mortgage lending industry experienced rapid growth from 2001 through 2005. In 2006, the industry experienced a slight decline which accelerated during 2007. We expect this decline to continue through 2008 and potentially beyond. Those investors who are still purchasing non-prime MBS have demanded higher rates of return as a risk premium on their investment because of increased incidences of delinquencies, early payment defaults, first payment defaults and fraud. This risk premium is passed on to borrowers in the form of higher mortgage interest rates and has decreased the economic incentives for many borrowers to refinance their existing mortgages. This risk premium to remaining non-prime MBS investors has increased the cost of, and therefore decreased the demand for, new mortgages. This decrease in mortgage loan originations has led, and may continue to lead, to fewer issuances of mortgage-backed securities. As a result, demand for our transaction management services has been, and will through 2008 and potentially beyond continue to be, materially reduced. Our historical performance may not be indicative of results that would occur in an environment in which there is a sustained downturn of mortgage loan originations, either because of rising interest rates, decreased demand for non-prime MBS or both. In these environments, our results of operations will likely be materially adversely affected.

The market for our services is highly competitive, and if we are not able to compete effectively, our business and results of operations may be adversely affected.

The market for our services is highly fragmented, intensely competitive and subject to rapid change. Our existing competitors, or future competitors, may have greater name recognition, larger client bases, better technology or data, easier access to data, lower priced services or greater financial, technical, personnel or other resources than we have. We compete with several providers of due diligence services, including large accounting firms and other providers focused on technology products, staffing services, surveillance and special servicing. Larger competitors with greater technical, personnel and financial resources may be better able to respond to the need for technological changes, compete for skilled professionals, build upon efficiencies based on a larger volume of loan transactions, fund internal growth and compete for market share generally. Among the ways in which we may encounter new or increased competition is the hiring or establishment by a competitor of a pool of skilled offshore workers that can provide many of the same services that we provide at substantially lower cost. Also, we may face competition from our clients if they choose to provide such services internally, as opposed to outsourcing these services to us, and from third parties who decide to expand their services, either organically or through merger or acquisition, to include some or all of the services that we provide. Increased competition could result in lower revenues and higher expenses, which could have an adverse effect on our business and results of operations.

Many of our largest clients are reducing their operations within the MBS market, which has adversely affected our business and results of operations, and consolidation amongst our clients could further adversely affected our business and results of operations.

As a result of recent increased incidences of delinquencies, early payment defaults, first payment defaults and fraud in non-conforming mortgages, many participants in the non-prime MBS market, including originators, issuers of MBS and investors, have dramatically reduced and in some instances ceased activity in their non-prime MBS-related business units. These participants, including some of the largest investment banks, have historically been the primary source of our revenue. We cannot make any assurance as to when or if these participants will increase their level of activity in the non-prime MBS markets, and we do not expect that they will resume their prior levels of activity in the near term. This diminution in activity has and will continue to adversely affect our business and results of operations.

Additionally, there has been, and may continue to be, substantial merger, acquisition and consolidation activity in the banking and financial services industry. The financial services industry includes many of our largest clients, and these clients may seek to diversify their service providers by utilizing our competitors to perform certain services that we provide. If our clients merge with or are acquired by other entities that are not our clients, or that use fewer of our services, they may discontinue or reduce their use of our services. Finally, the larger banks or financial institutions resulting from mergers or consolidations could decide to internally perform some or all of the services that we currently provide or may provide in the future, and thus terminate our engagements or decrease the level or volume of services we provide. Any of these developments could have an adverse effect on our business and results of operations.

If we are inefficient in delivering services to our customers, our profit margins may decrease and we may not be able to compete effectively.

The success of our business depends on delivering high-quality services to our clients in a timely manner. Our independent loan review specialists are a key component of our ability to deliver services. If we do not properly manage the activities of our independent loan review specialists and we experience a decrease in their productivity, especially in connection with client engagements that are billed on a per-file basis, our profit margins will be adversely affected. In order to maintain our profit margins in times of decreased productivity, we may increase the cost of our services to clients, which could result in reduced demand for our services and/or termination of client engagements with us. A reduction in services, a premature termination of engagements or our inability to increase prices could have an adverse effect on our business and results of operations.

Clients can terminate engagements with us at any time.

A majority of our transaction management engagements are project-based. Therefore, the utilization of our independent loan review specialists depends on our ability to secure additional engagements on a continual basis. Also, if a client terminates an engagement and we are unable to re-deploy our independent loan review specialists on another engagement within a short period of time, the independent loan review specialists may seek other opportunities for their services, which would increase our labor, recruiting and training costs and could have an adverse effect on our business and results of operations.

Maintaining our professional reputation and our key executives' professional reputation is critical to our future success, and any damage to this reputation may adversely affect our business and results of operations.

Our ability to secure new engagements and recruit and retain qualified employees and independent loan review specialists depends heavily on our and our key executives' strong reputation in the mortgage loan industry. Because we obtain a majority of our new engagements from existing clients, a client's dissatisfaction with our performance could seriously impair our ability to secure new engagements from that client and its affiliates. Diminution of our business reputation, or the reputation of our key executives, for any reason could make it substantially more difficult for us to compete successfully for new engagements.

Our engagements may result in professional liability.

Our services typically involve difficult analytical assignments and carry risks of professional and other liability. Many of our engagements involve matters that could have an impact on our clients' businesses. For example, our clients depend on us to accurately evaluate compliance with underwriting and regulatory criteria in connection with their analysis of mortgage securities. If a client incurs losses as a result of the services we provide, the client could threaten or bring litigation in order to recover damages or to contest its obligation to pay all or part of our fees. In some cases, a client may seek to recover its losses pursuant to indemnification rights. While our contracts generally provide for limitations on liability, litigation alleging that we performed negligently or otherwise breached our obligations to the client could expose us to significant liabilities and tarnish our reputation. In addition to the costs associated with litigation and claims, the perceived exposure to professional liability may make it more expensive to obtain and maintain insurance, including errors and omissions insurance. We believe that, in general, the likelihood of a client or a third party alleging that any service provider, such as Clayton, negligently completed their undertaking or otherwise committed a tortuous act that resulted in a negative financial consequence to them increases during market downturns. We cannot give any assurance that we will not be the target of such an allegation or claim during this period of turbulence in the non-prime MBS market. While we have not been subject to litigation to date, the occurrence of any such litigation or claim could have an adverse effect on our business and results of operations.

If we are not able to maintain accurate, comprehensive or reliable systems and data, we could experience reduced demand for our services.

Our success depends on our clients' confidence in the comprehensiveness, accuracy and reliability of our proprietary systems, transaction data and database of loan information. Additionally, we must continuously monitor changes to state predatory lending regulations and update our compliance software and data accordingly. The task of establishing and maintaining accurate and reliable systems and data is a continuous, complex, multi-step process. If our data, including the data we obtain from third parties, is not current, accurate, comprehensive or reliable or if there is an error in our systems resulting from events such as miscoding of rules or miscalculations of critical data elements, we could experience damage to our reputation or be subject to legal action, either of which could result in reduced demand for our services.

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

In connection with our loan file due diligence reviews and other consulting and advisory services that we provide to third parties relating to mortgage loans and mortgage-backed securities, we have access to personal financial information of the borrowers. This personal financial information is highly sensitive and confidential. If we or 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 assure 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 or future federal or state laws or regulations governing privacy.

An interruption in or breach of our information systems may result in lost business.

We rely heavily upon information systems to conduct our business. As we implement our growth strategy this reliance will increase. Any failure or interruption, or breach in security, of our information systems or the third-party information systems on which we rely could significantly impede our ability to operate our business. Although such failures, interruptions or breaches have not occurred in the past, we cannot assure that one will not happen in the future, or, if they do occur, that we or the third parties on whom we rely will adequately address them. We have implemented precautionary measures to avoid systems outages and to minimize the effects of any data systems interruptions, but we have not instituted fully redundant systems. If we do not build and maintain redundant systems for our data, current clients may terminate their engagements with us and potential clients may utilize one of our competitors for their service needs. The occurrence of any failure, interruption or breach could significantly harm our business. We may be required to expend significant capital and other resources to license additional technologies to protect against security breaches or to alleviate problems caused by any breach. We may be liable for any breach in our security and any breach could harm our reputation, reduce demand for our services or cause clients to terminate their relationships with us.

If we lose the services of certain key executive officers, we may not be able to execute our business strategy, manage our growth or compete effectively.

Our future success depends in large part on the continued service of our key executive officers, including Frank P. Filipps, our Chief Executive Officer, D. Keith Johnson, our President and Chief Operating Officer and Frederick C. Herbst, our Chief Financial Officer. Although we have employment and non-competition agreements with these executive officers, these individuals may nevertheless leave us. We cannot assure that these executive officers can be replaced with equally skilled and experienced professionals. Because these executive officers would be difficult to replace, the loss of their services could have an adverse effect on our business and results of operations.

Efforts to expand our product offerings beyond our current markets may not succeed.

We have focused on selling our services primarily in the residential non-agency MBS market. Although we currently offer services for other consumer and commercial loan types and related securities, we may expand further into these and other asset classes or geographic regions. We have also designed new products that leverage our data analytics capabilities, such as Clarity, InFront, InterCept and InCyt, and are beginning to market them to new classes of customers. Efforts to expand our product offerings beyond the principal market that we currently serve, however, may divert management resources from existing operations and require us to commit significant financial resources to developing new product offerings, which could have a material adverse effect on our business and results of operations. Moreover, efforts to expand beyond our existing markets may not result in the creation of new products that achieve market acceptance, create additional revenues or become profitable.

We may make acquisitions that prove unsuccessful or strain or divert our resources.

We intend to consider acquisitions of other companies in our industry that could complement our business, including the acquisition of entities that would expand our service offerings, increase our market share or offer access to other asset classes that we do not currently serve. We have limited experience in completing acquisitions of other businesses. If we do acquire other businesses, we may not be able to successfully integrate these businesses with our own and we may be unable to maintain our standards, controls and policies. We may fail in our attempt to integrate acquired companies and businesses in such a way that we can realize cross-selling opportunities and other synergies. Further, acquisitions may place additional constraints on our resources by diverting the attention of our management from our business operations. Through acquisitions, we may enter areas in which we have no or limited experience, and an acquisition may be unsuccessful in accomplishing the intended benefits of the transaction. Moreover, any acquisition may result in substantial transaction-related expenses, a potentially dilutive issuance of equity securities, the incurrence of debt or amortization of expenses and related intangible assets, all of which could have an adverse effect on our business and results of operations.

We have been downsizing our operations and may not be able to manage our growth or meet marketplace demands effectively if and when demand for our transaction management products and services resumes.

We have reduced capital expenditures and implemented additional cost-reduction initiatives, including reductions in personnel. Because of a lack of utilization during the current downturn, many of our experienced independent loan review specialists may pursue other livelihoods. If the non-agency MBS market were to recover quickly, we may not have adequate resources to meet our clients' demands for our transaction management products and services. Any such resurgence of demand could strain our management and our operational and financial resources. In addition, any such rapid growth in demand may adversely affect our ability to service our clients or the quality of services we provide. If we are unable to meet these demands, our competitors may be able to gain a greater market share in the transaction management and credit risk surveillance services market generally, as well as gain a greater share of our clients' business. We cannot assure that our infrastructure, operational, financial and management controls, reporting systems and procedures, facilities and personnel will be adequate to support our future operations or to effectively adapt to any future return to growth of the non-agency MBS market. If we cannot manage any material future growth effectively, our business and results of operations may be adversely affected.

Changes in the regulation of our business and our failure to comply with applicable laws and regulations may adversely affect our business and results of operations.

Our business is subject to various federal, state and local laws and regulations. Proposals for further regulation and changes in existing laws and regulation that affect our business are regularly being introduced and passed in state legislatures and the U.S. Congress. Legislative and regulatory proposals that are now receiving a great deal of attention relate, among other things, to predatory lending, subprime mortgage lending, secondary market securitization, rating agencies, bankruptcy laws and consumer protection initiatives relating to privacy and security of customer information. It is possible that these and one or more other legislative proposals or regulatory changes that may be adopted would have an adverse effect on our business. For example, any changes imposed on the secondary market for mortgages might increase the risk to our clients, issuers of non-agency MBS decreasing their demand for non-agency mortgages and decreasing the demand for our services. In addition, any changes to the current predatory lending regulations may increase our costs in connection with updating and conforming our High Cost Analyzer compliance application, or, conversely, reduce demand for our compliance-related services. Our failure to comply with these laws and regulations could harm our client relationships or our reputation, inhibit our ability to obtain new engagements, and expose us to class action lawsuits, breach of contract claims, and governmental proceedings, all of which could have an adverse effect on our business and results of operations.

Third parties may claim we are infringing their intellectual property rights, or may infringe upon or design around our intellectual property rights.

Our competitive position depends largely upon our proprietary products, processes and services. Third parties, however, may claim that we or our products, systems or operations infringe their intellectual property rights, and we may be unaware of intellectual property rights of others that may cover some aspects of our technology, products or services. Any litigation regarding trademarks, copyrights or other intellectual property rights could be costly and time consuming, and divert our management and key personnel from operating our business. If any third party has a meritorious or successful claim that we are infringing their intellectual property rights, we may be forced to change our products or services or to compensate such third parties, which may be costly or impractical. While we have not experienced any material claims or been subject to litigation to date, any such occurrence could have an adverse effect on our business and results of operations.

Our success and competitive position depend in part on our ability to obtain and maintain intellectual property rights protecting our products and services. We rely on a combination of copyrights, trademarks, service marks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our intellectual property and proprietary rights. We have received federal trademark registrations for CLAYTON and BEYOND DILIGENT, HIGH COST ANALYZER, HIGH COST FOCUS, CLAS, MASTEREPORTER, CLARITY and our Clayton logo. Our pending applications may not be registered by the U.S. Patent and Trademark Office, and third parties may challenge the validity or scope of the trademark applications or registrations. Despite our proprietary rights, there can be no assurance that others will not develop similar products, duplicate our products or design around our products.

CFIS has filed two patent applications (each with multiple claims) related to data filtering technology and one provisional application which relates to relates to its Question Portal, with the United States Patent Office. These patent applications may not be approved in whole or in part and consequently may not provide us with any protection from a competitive offering of services. Even if approved in whole or in part, these patents may not provide us with protection from competitive offerings. Defending patent rights may be expensive for us and there are no assurances we would be successful.

Our loan agreement contains operating and financial covenants that may restrict our business and financing activities.

In February 2008, we entered into an amendment to our senior loan agreement. We now maintain a $10.0 million revolving line of credit. After making at $25 million prepayment in connection with the amendment, the unpaid principal balance of our term loan was $23.9 million. Among other things, this senior loan agreement restricts our ability to:

- incur or guaranty additional indebtedness;
- make capital expenditures;
- create liens;
- enter into transactions with affiliates;
- make loans or investments;
- sell assets;
- pay dividends or make distributions on, or repurchase, our stock; or
- consolidate or merge with other entities.

Many of these restrictive covenants were further tightened in connection with our executing the February 2008 amendment. Among other things, this amendment requires us to maintain a minimum $6.0 million of liquidity (including any unused portion of the $10.0 million revolver commitment) and requires a $5,000,000 payment by March 31, 2009. In addition, our senior credit facility requires us to maintain specified financial covenants. The operating and financial restrictions and covenants in this credit facility, as well as any future financing agreements, may restrict our ability to finance our operations, engage in business activities or expand or pursue our business strategies. Our ability to comply with our obligations under the credit facility may be affected by events beyond our control. We may not be able to meet those obligations. A breach of any of our obligations under the credit facility could result in a default, cause any future indebtedness under the revolving line of credit that may be outstanding to become immediately due and payable, and terminate all commitments to extend further credit. We cannot assure that we will have sufficient assets to repay our credit facility upon any default. If we were unable to repay any outstanding indebtedness, the bank could proceed against the collateral granted to them to secure that indebtedness. We have pledged substantially all of our assets, including certain intellectual property, as collateral under the credit facility.

If we have weaknesses in our internal controls over financial reporting in the future, there could be an adverse effect on our financial reporting.

Though we have concluded, based on our evaluation as of December 31, 2007, our internal controls over financial reporting are effective, because of its inherent limitations, internal control over financial reporting may not prevent or detect all 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. Going forward, continued improvement of our internal controls and procedures will be required in order for us to manage future growth successfully and operate effectively as a public company. We cannot assure you that the continued maintenance of policies and procedures or any future measures will enable us to provide accurate and timely financial reports. Any failure to improve our internal controls and procedures could result in delays or inaccuracies in reporting financial information, or non-compliance with SEC reporting and other regulatory requirements, any of which could adversely affect our business and results of operation.

Risks Related to the Common Stock and Our Capital Structure

Future sales of our shares could adversely affect the market price of our common stock.

Our stockholders that held our stock prior to our initial public offering now hold a significant percentage of our outstanding shares of common stock. Any sale (or any distributions by partnership stockholders to their limited partners followed by a sale) by us or our current stockholders of our

common stock in the public market, or the perception that sales could occur, could adversely affect the prevailing market price for our common stock.

Substantially all of the holders of our common stock prior to our initial public offering have rights, subject to some limited conditions, to demand that we file a registration statement on their behalf to register their shares or that we include their shares in a registration statement that we file on our behalf or on behalf of other stockholders. If such demand rights are exercised pursuant to the terms and conditions of the registration rights agreement, we will incur significant expenses in connection with the filing of such registration statement. Additionally, the filing of a registration statement at the request of the stockholders may divert the attention of our senior management from our business operations.

Certain significant stockholders exercise significant control over Clayton.

Various significant stockholders and their affiliates, including TA Associates, collectively control a large percentage of our outstanding common stock. As a result, these stockholders are able to influence our management and affairs and all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control of Clayton and might affect the market price of our common stock.

We may require additional capital in the future, which may not be available to us. Issuances of our equity securities to provide this capital may dilute your ownership in us.

We may need to raise additional funds through public or private debt or equity financings in order to:

- fund our ongoing operations;
- take advantage of expansion opportunities;
- acquire complementary businesses or technologies;
- develop new services and products; or
- respond to competitive pressures.

Any additional capital raised through the issuance of our equity securities may dilute your percentage ownership interest in us. Furthermore, any additional financing we may need may not be available on terms favorable to us or at all. The unavailability of needed financing could adversely affect our ability to execute our growth strategy.

Provisions in our certificate of incorporation and by-laws may deter third parties from acquiring us.

Our certificate of incorporation and by-laws contain provisions that may make the acquisition of Clayton more difficult without the approval of our board of directors, including the following:

- our board of directors is divided into three classes serving staggered three-year terms;
- only our board of directors may call special meetings of our stockholders;
- our stockholders may take action only at a meeting of our stockholders and not by written consent;

we have authorized undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval;

stockholder approval of amendments of our certificate of incorporation or by-laws requires a vote of 75% of our outstanding shares;

- vacancies on the board of directors may be filled only by the directors;
- our directors may be removed only for cause by the affirmative vote of the holders of 75% of the votes that all stockholders would be entitled to cast in the election of directors; and
- we require advance notice for stockholder proposals.

These anti-takeover defenses could discourage, delay or prevent a transaction involving a change in control of Clayton. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors of your choosing and cause us to take other corporate actions that you desire.

Section 203 of the Delaware General Corporation Law may delay, defer or prevent a change in control that our stockholders might consider to be in their best interests.

We are subject to Section 203 of the Delaware General Corporation Law which, subject to certain exceptions, prohibits "business combinations" between a Delaware corporation and an "interested stockholder," which is generally defined as a stockholder who becomes a beneficial owner of 15% or more of a Delaware corporation's voting stock for a three-year period following the date that such stockholder became an interested stockholder absent prior approval of our board of directors. Section 203 could have the effect of delaying, deferring or preventing a change in control that our stockholders might consider to be in their best interests.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our headquarters are located in Shelton, Connecticut, and we have additional offices in Denver, Colorado; Tampa, Florida; Costa Mesa, California; and Bristol, England. All of our offices and facilities are leased. We do not consider any specific leased facility to be material to our operations. We believe that equally suited facilities are available in several other areas throughout the United States and Europe.

The following table summarizes information with respect these facilities:

Location	Principal Activities	Area (sq. feet)	Lease Expiration Date
Shelton, Connecticut	Headquarters	66,000	2010 and 2013(1)
Denver, Colorado	CFIS corporate offices and operations	46,086	2009
Tampa, Florida	Centralized underwriting	51,134	2017
Costa Mesa, California	Sales and administration	5,467	2009
Bristol, England	Due diligence services	975	2008

(1) At December 31, 2007, we leased two floors in an office building in Shelton, Connecticut. In February 2008, we terminated the lease to one of these floors which was to expire in 2010. See Note 20 to our consolidated financial statements.

Item 3. Legal Proceedings

From time to time, we may be a party to various claims, suits and complaints. Currently, there are no such claims, suits or complaints that, in our opinion, would have a material adverse effect on our business, results of operations and financial condition.

On June 22, 2007, Clayton Holdings, Inc. received a subpoena from the Attorney General of the State of New York seeking information and documents relating to the transaction management services that Clayton provides to its clients in the subprime mortgage industry. Clayton has agreed to continue to cooperate with this investigation and, if requested, provide testimony regarding the same. In exchange for our continued cooperation, Clayton has received immunity from civil and criminal prosecution by the State of New York. Clayton has also received a voluntary information request from the Securities and Exchange Commission, and information subpoenas from the Attorney General of the State of Connecticut, and the Attorney General of the Commonwealth of Massachusetts. Clayton is cooperating fully with these investigations. For more information see Part I, Item 1A "Risk Factors."

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of our security holders through a solicitation of proxies or otherwise during the quarterly period ended December 31, 2007.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock is listed and has been traded on the Nasdaq Global Market under the symbol "CLAY" since our initial public offering on March 24, 2006. Prior to that time there was no public market for our common stock.

The following table sets forth the high and low closing prices of our common stock, as reported by the Nasdaq Global Market, for each of the periods listed.

	High	Low
2006		
First Quarter (commencing March 24, 2006)	$ 22.49	$ 19.75
Second Quarter	$ 23.33	$ 11.45
Third Quarter	$ 13.53	$ 10.29
Fourth Quarter	$ 18.94	$ 11.66
2007		
First Quarter	$ 24.30	$ 14.81
Second Quarter	$ 20.50	$ 10.81
Third Quarter	$ 12.14	$ 5.91
Fourth Quarter	$ 8.27	$ 3.15
2008		
First Quarter (through February 29, 2008)	$ 5.64	$ 3.00

Holders

As of February 29, 2008, there were 11 holders of record of our common stock.

Dividends

Our board of directors will have discretion in determining whether to declare or pay dividends, which will depend upon our financial condition, results of operations, capital requirements and such other factors as the board of directors deems relevant. We currently anticipate that we will retain future earnings for the development, operation and expansion of our business. Moreover, our senior loan agreement relating to our senior credit facility imposes restrictions on our ability to declare and pay dividends.

Performance Graph

This performance graph shall not be deemed "filed" with the SEC or subject to Section 18 of the Exchange Act, nor shall it be deemed incorporated by reference in any of our filings under the Securities Act of 1933, as amended.

The following line graph compares the cumulative total stockholder return on our common stock with the cumulative total return of the Russell 2000 Index and the Dow Jones Wilshire 5000 Financials Index for the period beginning on March 24, 2006, the date of our initial public offering, and ending on December 31, 2007. We obtained this information from sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. The comparison assumes the investment of $100 in our common stock and each of the foregoing indices and reinvestment of all dividends. The total return performance shown on the graph is not necessarily indicative of future total return performance.

	3/31/2007	6/30/2007	9/30/2007	12/31/2007
Clayton Holdings, Inc.	$ 71.09	$ 52.78	$ 37.12	$ 23.96
Russell 2000 Index	107.45	112.19	108.72	103.74
D J Wilshire 5000 Financials Index	117.14	118.71	113.98	100.41

	3/24/2006	3/31/2006	6/30/2006	9/30/2006	12/31/2006
Clayton Holdings, Inc.	$ 100.00	$ 100.38	$ 62.14	$ 59.86	$ 89.10
Russell 2000 Index	100.00	101.56	96.45	96.88	105.50
D J Wilshire 5000 Financials Index	100.00	104.60	104.08	111.50	119.57

Recent Sales of Unregistered Securities

None.

Use of Proceeds from Registered Securities

Not applicable.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Upon termination, during the three months ended December 31, 2007, employees forfeited 14,250 unvested shares of restricted stock, as detailed in the following table:

Period	Total Number of Shares Forfeited
November 1, 2007 November 30, 2007	6,750
December 1, 2007 December 31, 2007	7,500

Item 6. Selected Financial Data

The following selected consolidated financial data should be read in conjunction with the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7. of this Annual Report on Form 10-K and the section entitled "Financial Statements and Supplementary Data" in Part II, Item 8. of this Annual Report on Form 10-K.

In accordance with U.S. GAAP relating to companies under common control prior to their combination, the financial statements of the previously separate companies under common control are restated on a combined basis from the dates of their respective acquisitions by the controlling entity. Accordingly, for accounting purposes, the date of our inception was May 24, 2004, the date that TA Associates acquired CFIS, the first of the combined entities that were brought under common control. Our consolidated results of operations presented on a "Successor Basis" include the accounts of the holding companies of each of Clayton Services and its subsidiaries, including First Madison, and CFIS, formerly The Murrayhill Company, beginning from the dates of the acquisitions of controlling interests by TA Associates, which were August 2, 2004 and May 24, 2004, respectively. Our consolidated results of operations for the period from January 1, 2004 through August 1, 2004, are prepared on a "Predecessor Basis," and reflect solely the financial position and results of operations of Clayton Services. *See "Management's Discussion and Analysis of Financial Condition and Results of Operations Other Factors Affecting Comparability."*

The data presented on a "Successor Basis" for the years ended December 31, 2007, 2006 and 2005, and as of December 31, 2007 and 2006 is derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The data presented on a "Successor Basis" for the period from inception through December 31, 2004 as well as the data presented on a "Predecessor Basis" for the period from January 1, 2004 through August 1, 2004 and for the year ended December 31, 2003, and as of December 31, 2003, is derived from our audited consolidated financial statements that are not included elsewhere in this Annual Report on Form 10-K. Results for the year ended December 31, 2007 are not necessarily indicative of results expected for any other future period.

SELECTED CONSOLIDATED FINANCIAL DATA

	Successor				Predecessor	
	Year ended December 31,			Inception through December 31, 2004	January 1, 2004 through August 1, 2004	Year ended December 31,
	2007	2006	2005			2003
	(Amounts in thousands, except share and per share data)					
CONSOLIDATED STATEMENTS OF OPERATIONS:						
Revenue	$ 152,597	$ 232,706	$ 207,502	$ 79,805	$ 76,339	$ 85,228
Cost of services:						
Compensation expense	72,539	112,953	99,675	37,252	35,502	39,436
Travel and related expenses	11,156	26,108	29,787	13,892	15,494	17,204
Other direct costs	5,790	9,677	6,066	1,304	2,668	3,821
Total cost of services	89,485	148,738	135,528	52,448	53,664	60,461
Gross profit	63,112	83,968	71,974	27,357	22,675	24,767
Operating expenses						
Salaries and benefits	21,060	21,266	18,911	6,553	3,783	4,403
Other selling, general and administrative expenses	23,282	18,517	17,181	6,417	4,276	3,960
Depreciation and amortization	9,286	7,558	4,694	1,115	792	1,163
Amortization of intangibles	9,305	10,168	10,175	4,509		
Loss on impairment	92,843	279	1,632			
Total operating expenses	155,776	57,788	52,593	18,594	8,851	9,526
(Loss) income from operations	(92,664)	26,180	19,381	8,763	13,824	15,241
Other income	28					315
Interest expense, net	3,735	7,986	8,189	3,066	178	268
Loss from extinguishment of debt	134	886	2,991			
(Loss) income from continuing operations before income taxes	(96,505)	17,308	8,201	5,697	13,646	15,288
Income tax (benefit) expense	(4,316)	7,143	3,153	2,354	260	(62)
(Loss) income from continuing operations	(92,189)	10,165	5,048	3,343	13,386	15,350
Loss from discontinued operations	5,050	2,289				
Net (loss) income	$ (97,239)	$ 7,876	$ 5,048	$ 3,343	$ 13,386	$ 15,350
Pro forma net income(1)					$ 8,324	$ 9,326
Net (loss) income per share(2)						
Basic:						
Continuing operations	$ (4.41)	$ 0.55	$ 0.42	$ 0.37	$ 0.82	$ 0.92
Discontinued operations	(0.24)	(0.12)				
Total	$ (4.65)	$ 0.43	$ 0.42	$ 0.37	$ 0.82	$ 0.92
Diluted:						
Continuing operations	$ (4.41)	$ 0.53	$ 0.41	$ 0.37	$ 0.82	$ 0.92
Discontinued operations	(0.24)	(0.12)				

	Successor				Predecessor	
Total	$ (4.65)	$ 0.41	$ 0.41	$ 0.37	$ 0.82	$ 0.92
Pro forma weighted average shares(2)						
Basic	20,913,812	18,497,195	11,888,671	9,034,350	10,162,309	10,162,309
Diluted	20,913,812	19,281,552	12,304,627	9,095,537	10,162,309	10,162,309
(Amounts in thousands)						
ADDITIONAL DATA:						
Adjusted EBITDA(3)	$ 18,798	$ 44,185	$ 35,882	$ 14,387	$ 14,616	$ 16,719

	Successor				Predecessor
	As of December 31,				
	2007	2006	2005	2004	2003
	(Dollars in thousands)				
SELECTED CONSOLIDATED BALANCE SHEET DATA:					
Cash and cash equivalents	$ 40,199	$ 22,882	$ 7,209	$ 12,450	$ 4,669
Accounts receivable, net	12,018	37,452	37,205	21,658	22,047
Unbilled receivables, net	4,457	14,951	14,926	17,655	9,049
Goodwill	34,595	69,843	69,843	46,179	
Intangibles assets, net	13,235	74,294	84,740	96,522	
Total assets	130,201	262,913	247,505	218,247	42,554
Revolving credit facility and term loans	48,899	64,599	150,000	41,777	10,429
Subordinated and senior subordinated notes				29,486	
Series A convertible preferred stock			12,258	27,190	
Series B convertible preferred stock			43,867	74,513	
Total stockholders' equity	62,367	157,729	12,542	7,224	25,771

(1) As an S-corporation, our Predecessor was not subject to corporate level federal income taxes. For comparison purposes, for all Predecessor periods we have presented pro forma net income, which reflects income taxes assuming we had been a C-corporation during such periods and assuming a combined tax rate of 39.0% for federal and state income taxes. The pro forma net income information is unaudited.

(2) For all Predecessor periods, pro forma net income per share and pro forma weighted average shares assume we had been a C-corporation since the beginning of the period presented. The pro forma net income per share and pro forma weighted average shares information is unaudited. For all Successor periods, net (loss) income per share and pro forma weighted average shares are the actual net income per share and weighted average shares for the period presented.

(3) Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") represents income from operations before interest expense, income taxes, depreciation and amortization. For the years ended December 31, 2007, 2006 and 2005, EBITDA has been adjusted for loss from extinguishment of debt and impairment losses. EBITDA does not represent and should not be considered as an alternative to net income or cash flow from operations, as determined by U.S. GAAP. We present Adjusted EBITDA because we believe that it is widely accepted that EBITDA provides useful information regarding our operating results. We rely on Adjusted EBITDA primarily as an operating performance measure in order to review and assess our operations and our management team. For example, our management incentive compensation is based in part upon our achieving minimum EBITDA targets for a given year. Our loan covenants with our primary lender are measured using EBITDA as a key liquidity measure. We believe that it is useful to investors to provide disclosures of our operating results on the same basis as that used by our management. We also believe that it can assist investors in comparing our performance to that of other companies on a consistent basis without regard to depreciation, amortization, interest or income taxes, which do not directly affect our operating performance. EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under U.S. GAAP. Some of these limitations are:

- EBITDA does not reflect our cash expenditures, or future requirements, for capital expenditures or contractual commitments;
- EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our debts;
- Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect any cash requirements for such replacements; and
- Other companies in our industry may calculate EBITDA differently than we do, limiting its usefulness as a comparative measure.

A reconciliation of Adjusted EBITDA to (loss) income from continuing operations before income taxes is set forth below:

	Successor				Predecessor	
	Year ended December 31,			Inception through December 31, 2004	January 1, 2004 through August 1, 2004	Year ended December 31,
(Dollars in thousands)	2007	2006	2005			2003
(Loss) income from continuing operations before income taxes	$ (96,505)	$ 17,308	$ 8,201	$ 5,697	$ 13,646	$ 15,288
Interest expense, net	3,735	7,986	8,189	3,066	178	268
Loss on extinguishment of debt	134	886	2,991			
Loss on impairment	92,843	279	1,632			
Depreciation and amortization	18,591	17,726	14,869	5,624	792	1,163
Adjusted EBITDA	$ 18,798	$ 44,185	$ 35,882	$ 14,387	$ 14,616	$ 16,719

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with our consolidated financial statements and related notes thereto. In addition to historical information, this discussion contains forward-looking statements that involve risks, uncertainties and assumptions that could cause actual results to differ materially from management's expectations. Factors that could cause such differences include those described in "Risk Factors" in Part 1, Item 1A. in this Annual Report on Form 10-K.

Overview

We provide a full suite of outsourced services, mortgage-related analytics and specialized consulting services for buyers and sellers of, and investors in, mortgage-related loans and securitizations. Our services include:

- transaction management, which consists of due diligence, professional staffing services, compliance products and services, consulting and conduit support services;
- oversight and reporting on mortgage-backed securities (credit risk management and surveillance); and
- specialized loan servicing services (special servicing) and consulting services.

We use proprietary technology and processes to provide these services throughout the full lifecycle of a loan, from loan origination, aggregation and securitization to the surveillance and administration of loans and securities.

We provide a majority of our services to participants in the non-agency mortgage-backed securities, or MBS, market and the non-conforming mortgage loan market. We have long-standing client relationships with many of the leading capital markets firms, banks and lending institutions, including the largest MBS issuers/dealers, mortgage and bond insurance companies and fixed income investors. We believe that we are a leading provider of these services to our clients due to our many years of experience, our deep knowledge of the industry and our database of non-conforming loan transactions. During 2007, we performed detailed analyses on approximately 448,000 loans totaling approximately $100 billion in principal value, which represented approximately 9% of the total principal balance of U.S. non-conforming mortgage loan originations over such period. As of December 31, 2007, we were monitoring approximately $454 billion in loans underlying MBS.

Conforming residential mortgage loans are loans that adhere to the underwriting guidelines of the government sponsored entities, or GSEs, such as the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). Non-conforming residential mortgage loans are loans that do not meet the underwriting guidelines of the GSEs, typically because of one or a combination of the following: loan size, borrower credit profile, loan to value ratio, documentation or type of loan.

MBS issued by GSEs are referred to as agency MBS and have historically comprised a majority of the residential MBS that have been issued. A large segment of the MBS market includes private-label, or non-agency, issuers such as capital markets firms and banks.

We generate the majority of our revenue from the services we provide to support the large non-agency MBS and non-conforming mortgage loan markets. In 2007, the aggregate principal value of new issuances of non agency MBS was $707 billion, up from $136 billion in 2000, although the 2007 total was down significantly from $1,146 billion in 2006. The principal balance of non-conforming mortgage loan originations was $1,168 billion in 2007, up from $390 billion in 2000, although the 2007 total was down significantly from $1,910 billion in 2006. Securitization rates for non-conforming mortgage loans have increased from 34.6% in 2000 to 57.9% in 2007, however the 2007 rate was down slightly from 58.8% in 2006. We believe the volume of non-agency MBS securitizations and non-conforming mortgage loan originations will be significantly lower in 2008 than in 2007. With recovery in the mortgage markets, we believe that several factors support the demand for our services over the long-term, including:

- investors' growing demand for transparency, independent validation of data and third-party oversight of loans collateralizing MBS;
- the desire for outsourced services by capital markets firms and other major mortgage loan market participants; and
- the increased complexities and requirements of federal, state and local regulations applicable to the mortgage loan industry.

Our revenue is also driven by non-agency MBS issuance and the aggregate number of non-conforming mortgage loan originations. Changes in the volume of non-agency MBS issuances and non-conforming mortgage loan originations may impact the number of loans for which we perform our services, leading to a corresponding change in gross revenue. We are increasingly utilizing our centralized underwriting facilities to perform our services which should reduce the amount of per-loan travel expenses.

The volume of non-agency MBS securitizations declined by 38% and non-conforming mortgage loan originations declined by 39% in 2007 as compared to 2006. The markets deteriorated throughout 2007, with non-agency MBS issuance declining by 81% and non-conforming loan originations declining by 69% in the fourth quarter as compared to the comparable period in 2006. In 2007, the non-conforming mortgage sector was characterized by turmoil and deteriorating conditions including the withdrawal of credit by warehouse credit lenders, bankruptcy of multiple industry participants, tightening of underwriting standards, increased mortgage delinquencies and defaults by borrowers, reduced origination volumes, downgrades by credit rating agencies, decreasing liquidity in the secondary mortgage market and reductions in personnel, among others. In addition, nearly all industry participants project that the volume of non-agency MBS securitizations and non-conforming mortgage loan originations will be lower in 2008 than 2007. In response to the current environment, we are optimizing our organizational structure by reducing operating costs, including a reduction in the number of employees and the closure of certain operating locations. Should the market continue to deteriorate and result in significantly decreased revenues, additional reductions to our operating costs could result. We do believe the non-agency MBS securitizations and non-conforming mortgage loan markets will rebound from the volumes experienced in the fourth quarter of 2007; however, the timing and magnitude of this recovery is uncertain. While we expect these conditions will impact our earnings adversely in the near term, we believe that the challenges facing the industry could ultimately benefit us. We believe there will be continued demand for new loan products and increased home ownership driven in part by first-time homeowners. In addition, we believe MBS investors and regulators will seek additional transparency, independence and disclosure relating to data provided on the loans collateralizing MBSs, which could increase demand for our services over the long term.

Basis of Presentation

We were formed as a Delaware corporation in March 2005, following the combination of the holding companies of each of Clayton Services and its subsidiaries, including First Madison, and CFIS, formerly The Murrayhill Company, or Murrayhill. Prior to the combination, each holding company was controlled by investment funds affiliated with TA Associates. In accordance with US GAAP relating to companies under common control prior to their combination, the financial statements of the previously separate companies under common control are restated on a combined basis from the dates of their respective acquisitions by the controlling entity. Accordingly, for accounting purposes, the date of our inception was May 24, 2004, the date that investment funds affiliated with TA Associates acquired CFIS, the first of the combined entities that were brought under common control.

Critical Accounting Policies

Management has discussed the development and selection of these critical accounting estimates with the Audit Committee of our Board of Directors and our Audit Committee has reviewed our disclosures relating to them.

Basis of Presentation

In preparing our financial statements in conformity with US GAAP, we have to make estimates and assumptions about future events that affect the amounts of reported assets, liabilities, revenues and expenses, as well as the disclosure of contingent assets and liabilities in the financial statements and accompanying notes. Some of our accounting policies require the application of significant judgment by management in the selection of appropriate assumptions for determining these estimates. By their nature, these judgments are subject to an inherent degree of uncertainty; therefore, we cannot assure that actual results will not differ significantly from estimated results. We base these judgments on our historical experience, management's forecasts and other available information, as appropriate.

Our most critical accounting policies, which reflect significant management estimates and judgment in determining reported amounts in the consolidated financial statements are as follows:

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the service has been performed, the fee is fixed and determinable, and collection of the resulting receivable is reasonably assured.

We derive most of our revenue from professional service activities. Revenue consisting of billed fees and pass-through expenses is recorded as work is performed and expenses are incurred. Revenue also includes expenses billed to clients, which include travel and other out-of-pocket expenses, and other reimbursable expenses. Revenue also includes termination fees in connection with clients' early termination of contracts.

We record provisions for fee adjustments and discretionary pricing adjustments as a reduction of revenue. Revenue recognized, but not yet billed to clients, has been recorded as unbilled receivables in the Company's consolidated balance sheets.

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Accounting for Stock Based Compensation" which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. This standard requires an issuer to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under Accounting Principles Board ("APB") Opinion No. 25. In March 2005, the SEC released Staff Accounting Bulletin ("SAB") 107, "Share-Based Payment," which expresses views of the SEC Staff about the application of SFAS No. 123(R). SFAS No. 123(R) became effective for annual reporting periods beginning on or after June 15, 2005. We previously adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," for all awards granted to employees. On January 1, 2006, we adopted SFAS No. 123(R) and it did not have a material impact on our financial statements.

According to the provisions of incentive stock option agreements between the Company and its employees, the vesting term for certain options outstanding as of the date of the IPO accelerated by either one year or twenty percent, varying in accordance with the terms of the employee's specific incentive stock option agreement. In addition, 130,208 of performance based options became immediately vested. Therefore, on March 29, 2006, we recognized $611,696 of additional compensation expense from this accelerated vesting.

Options to purchase 27,500 shares were granted in the year ended December 31, 2007, with an average exercise price of $12.58 per share. In addition, 1,131,832 shares of restricted stock were awarded during the year ended December 31, 2007.

Valuation of Long-lived Assets Excluding Goodwill

We evaluate all of our long-lived assets, including intangible assets other than goodwill and fixed assets, periodically for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS No. 144). SFAS No. 144 requires that long-lived assets be evaluated for impairment when events or changes in facts and circumstances indicate that their carrying value may not be recoverable. If events or circumstances indicate that the carrying value of an asset may not be recoverable, we assess the recoverability of identified intangible assets by comparing the projected undiscounted net cash flows associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. The amount of impairment will be measured as the difference between the carrying value and the fair value of the impaired asset. An impairment will be recorded as an operating expense in the period of the impairment and as a reduction in the carrying value of that asset.

In the quarter ended December 31, 2007, the Company recorded a charge of $2,334,896 to reflect the impairment of software associated with the transaction management segment.

Accounts Receivable

We are required to estimate the collectibility of accounts receivable. A considerable amount of judgment is required in assessing the likelihood of realization of receivables. Relevant assessment factors include the creditworthiness of the customer, our prior collection history with the customer and related aging of past due balances. Specific accounts receivable are evaluated when we believe a customer may not be able to meet its financial obligations due to a deterioration of its financial condition or its credit ratings. The allowance requirements are based on the best facts available and are re-evaluated and adjusted on a regular basis and as additional information is received.

Intangible Assets

Intangible assets consist of customer relationships, technology, trade name and trademarks, non-competition agreements and excess of cost over fair value of net assets acquired, or goodwill. Customer relationships are the value of the specifically acquired customer relationships. Technology is the value of recreating the completed technology infrastructure. Trade name and trademarks are the value inherent in the recognition of "Clayton" and the other names that we use. The value of the non-competition agreements are an appraisal of potential lost revenues that would arise from an individual initiating a competing enterprise.

Except for goodwill, trade names and trademarks, all intangible assets are stated at cost less accumulated amortization. The costs attributable to the identified intangibles were based on a number of significant assumptions as determined by the Company and its independent appraisal expert. Identifiable intangible assets with finite lives are amortized under the straight-line method over their applicable estimated useful lives.

The Company adopted SFAS No. 142 "Goodwill and Other Intangible Assets" ("SFAS No. 142"), which provides, among other things, that goodwill and intangibles with indefinite lives are no longer amortized but are reviewed for impairment at least annually (beginning with the first anniversary of the acquisition date). An impairment test was conducted in June 2007 and there was no impairment to goodwill or other intangibles. During the fourth quarter of 2007, due to the continued turmoil in the subprime mortgage loan and securitization markets, and industry projections of mortgage loan and securitization activity for 2008 and 2009, the Company re-tested its goodwill and other intangible assets for impairment and determined that certain goodwill and other intangible assets were impaired.

In the quarter ended December 31, 2007, the Company recorded a charge of $90,508,095 to reflect the impairment of goodwill and other intangible assets associated with the transaction management segment. In December 2006, the Company recorded a charge of $279,458 to reflect the impairment of certain customer relationships associated with the special servicing segment. In October 2005, the Company's Board of Directors approved the discontinuance of the use of the trade name "Murrayhill" and the Company recorded an impairment charge of $1,631,700.

Income Taxes

We recognize deferred income tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred income tax liabilities and assets are determined based on the difference between the financial statement and the tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We recognize deferred tax assets if it is more likely than not that the assets will be realized in future years and a valuation allowance on the deferred tax assets if they are deemed to be impaired.

We adopted FASB Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes," on January 1, 2007.

Revenue

We generate a majority of our revenue by providing professional outsourced services across the lifecycle of a mortgage loan.

Our transaction management services are provided under "time-and-materials" or per-file billing arrangements. Under "time-and-materials" arrangements, we bill our clients on an hourly basis with travel and other reimbursable expenses passed through and recognized as revenue. Under per-file billing arrangements, we bill our clients for each file reviewed with travel and other reimbursable expenses passed through separately or included in the per-file rate. Revenues consisting of billed fees and pass-through expenses, which include travel and other reimbursable expenses, are recorded as work is performed and expenses are incurred. Revenue also includes termination fees in connection with client's early termination of contracts. Revenues recognized, but not yet billed to clients, have been recorded as unbilled receivables in our consolidated balance sheets. For the years ended December 31, 2007 and 2006, transaction management revenue accounted for 63.6% and 79.4%, respectively, of total revenue. Due to the continued turmoil in the subprime mortgage loan and securitization markets, and industry projections of lower mortgage loan and securitization activity for 2008 and 2009, we believe the demand for our transaction management services, and therefore our revenues, will be lower in the foreseeable future. During the last half of 2007, we instituted a cost reduction program which included workforce reductions and limits regarding discretionary spending in order to scale back expenditures to reflect the decline in our revenues. In addition, we continue to develop new products and services and actively seek new customers for our existing products and services. We believe these actions will mitigate the effect of the downturn in the subprime market on the financial performance of our transaction management business and position us to capitalize on opportunities when the industry recovers and transaction volumes rebound. However, there can be no assurance that these actions will be successful.

Our credit risk management and surveillance services provide a revenue stream which is generally recurring in nature. In a typical MBS transaction for which we provide surveillance services, we are engaged by the trustee of an MBS issuance to provide our services over the life of the trust and are paid monthly directly from the cash flow of the trust. A majority of our surveillance revenue is based upon a negotiated rate multiplied by the outstanding principal balance of the underlying mortgage loans in the MBS issuance. Revenues in this business segment are dependent upon the value of loans subject to surveillance. Based on the factors noted above, we believe the volume of new securitizations will decline in the foreseeable future. As a result, it is likely that the size of the portfolio of loans under surveillance will decline, as loan satisfactions are anticipated to exceed new loans being added to our surveillance portfolio. Therefore, our revenues in this business segment are likely to decrease. These fees are recognized each month as services are rendered. For the years ended December 31, 2007 and 2006, surveillance services revenue accounted for 29.6% and 15.0%, respectively, of total revenue.

Our special servicing activities are conducted under annual or multi-year contracts for which we typically receive revenue on a per loan per month basis as well as incentive fees. For the years ended December 31, 2007 and 2006, special services revenue accounted for 6.8% and 5.6%, respectively, of total revenue. Our contract with one customer within this unit expired as of December 31, 2007 and was not renewed. Revenues from this customer were $6.6 million and $6.1 million for the years ended December 31, 2007 and 2006, respectively.

For the year ended December 31, 2007, no single client represented greater than 10% of revenues.

For the year ended December 31, 2006, revenue from our largest two clients, Morgan Stanley and Deutsche Bank, accounted for an aggregate of 24.4% of total revenue. Each of these clients accounted for more than 10% of our total revenue. This revenue is primarily associated with the transaction management segment.

Cost of Services

Compensation Expense

Compensation expense consists primarily of compensation for independent loan review specialists and employees directly involved in the delivery of our services, which include our client service managers who manage our engagements. Compensation expense also includes payroll related benefits for our direct employees. The professionals we retain from a professional employment organization, including our independent loan review specialists, do not receive any employee benefits from us and are only compensated for actual hours worked. Our direct cost of operations does not include an allocation of overhead costs.

Travel and Related Expenses

Travel and related expenses consist of expenses incurred in enabling employees and independent loan review specialists to travel to clients' sites and are comprised of airfare, hotel and car rental expenses. A majority of these expenses are either directly billed to clients or included in the per-file rates charged. As such, these expenses are directly or indirectly included in our revenue.

Other Direct Costs

Other direct costs include the cost of third-party mortgage loan services (primarily collateral appraisal fees), outside support for our compliance services used in connection with our loan reviews, independent loan review specialist training and miscellaneous non-billable transaction costs.

Operating Expenses

Operating expenses primarily consist of corporate overhead costs not directly associated with a specific transaction or contract, such as salaries and benefits, marketing and administrative expenses, professional fees and depreciation and amortization expenses.

In connection with becoming a public company, we have incurred significant additional operating expenses such as increased audit fees, professional fees, directors and officers' insurance costs, compensation for our board of directors, and expenses related to hiring additional personnel and expanding our administrative functions. Many of these expenses either were not incurred or were incurred at a lower level by us as a private company.

Salaries and Benefits

Salaries and benefits consist of employee compensation for those employees who are not directly billable to a particular assignment including costs of administrative, finance, human resources, technology, marketing, business development and executive personnel.

Other Selling, General and Administrative Expenses

Other selling, general and administrative expenses consist of costs such as rent and utilities, marketing, advertising and promotion expenses, non-reimbursable travel and entertainment, information technology, insurance, education, training and hiring expenses other than for independent loan review specialists and professional fees consisting of legal, accounting and other consulting fees in connection with the ongoing operation of our business including audit and Sarbanes-Oxley Act of 2002 compliance.

Depreciation and Amortization

We incur depreciation and amortization expenses for costs related to the capitalization of property and equipment and software developed for internal use on a straight-line basis over the estimated useful lives of the assets, which range from three to seven years. Leasehold improvements and assets under capital lease are amortized over the shorter of the estimated useful life of the asset or the lease term.

Treatment of Goodwill and Amortization of Intangibles

We also incur amortization expenses for costs related to the capitalization of identifiable intangible assets including customer relationships, technology and non-competition agreements.

We account for acquisitions of companies in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (SFAS No. 141). We allocate purchase price to tangible assets, intangible assets, and liabilities based on fair values with the excess of purchase price amount being allocated to goodwill. The allocation of the purchase price to these intangible assets is based on a number of significant assumptions as determined by us and in the case of material acquisitions our independent appraisal expert, including evaluations of the future income producing capabilities of these assets and related future expected cash flows. We also make estimates about the useful lives of the acquired intangible assets. Should different conditions result in the determination that the value of the goodwill and acquired intangible assets has been impaired, we could incur write-downs of goodwill or intangible assets, or changes in the estimation of useful lives of those intangible assets. In accordance with SFAS No. 142, goodwill is not amortized, but is subject to annual impairment testing which is discussed in greater detail below.

In accordance with SFAS No. 142, goodwill is subject to annual impairment tests or on a more frequent basis if events or conditions indicate that goodwill may be impaired. Goodwill is tested for impairment at a level of reporting referred to as a reporting unit. The first step of our annual test is to compare the fair value of our shares to the carrying value of our net assets of the reporting unit. If we determine that our carrying value exceeds our fair value, we would conduct a second step to the goodwill impairment test. The second step compares the implied fair value of the goodwill (determined as the excess fair value over the fair value assigned to our other assets and liabilities) to the carrying amount of goodwill. When the carrying amount of goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized.

We evaluate all of our long-lived assets, including intangible assets other than goodwill and fixed assets, periodically for impairment in accordance with SFAS No. 144. SFAS No. 144 requires that long-lived assets be evaluated for impairment when events or changes in facts and circumstances indicate that their carrying value may not be recoverable. If events or circumstances indicate that the carrying value of an asset may not be recoverable, the amount of impairment will be measured as the difference between the carrying value and the fair value of the impaired asset. An impairment will be recorded as an operating expense in the period of the impairment and as a reduction in the carrying value of that asset. In the quarter ended December 31, 2007, the Company recorded a charge of $90,508,095 to reflect the impairment of certain goodwill and other intangibles associated with the transaction management segment. In December 2006, the Company recorded a charge of $279,458 to reflect the impairment of certain customer relationships associated with portfolio management. In October 2005, the Company's Board of Directors approved the discontinuance of the use of the trade name "Murrayhill" and the Company recorded an impairment charge of $1,631,700.

Net Interest Expense

Net interest expense consists of interest paid on our debt net of interest received on our cash balances.

Interest expense for the year ended December 31, 2007, primarily consisted of interest on our term loan and amortization of debt issuance costs related to the term loan and revolving line of credit. Our term loan had a balance at January 1, 2007, of $64,598,998, and $48,899,269 at December 31, 2007. On February 21, 2008, in connection with an amendment to our credit agreement, the interest rate on amounts outstanding under our debt facility increased 125 basis points to LIBOR plus 3% or the Prime Rate plus 2%.

Interest expense for the year ended December 31, 2006, primarily consisted of interest on our term loan, amortization of debt issuance costs related to the term loan and revolving line of credit, and interest on our revolving line of credit. Our term loan had a balance at January 1, 2006 of $150,000,000, and $64,598,998 at December 31, 2006.

Interest expense for the year ended December 31, 2005 primarily consisted of interest on our prior term loan, which had a balance of $37,750,000 at the start of the period, and interest on 12% senior subordinated and 12% subordinated notes issued to TA Associates and our other noteholders in connection with the acquisitions of Clayton Services and CFIS, respectively, by investment funds affiliated with TA Associates. Our term loan had a balance at January 1, 2005 of $37,750,000. The combined balance of the 12% senior subordinated and 12% subordinated notes at January 1, 2005 was $29,486,478. The remaining balances of the prior term loan, the 12% senior subordinated notes and the 12% subordinated notes were repaid with the proceeds from our $150,000,000 term loan on December 8, 2005.

Loss from Extinguishment of Debt

Due to the prepayment of $15,000,000 on our term loan during the year ended December 31, 2007, we expensed a portion of the debt issuance costs on the term loan and recognized a loss from extinguishment of debt of $45,043 during the first quarter of 2007, $45,289 during the second quarter of 2007 and $43,568 during the third quarter of 2007.

On March 29, 2006, following our initial public offering, we repaid $70,000,000 of the outstanding balance on our $150,000,000 term loan and the entire $7,400,000 outstanding balance on our revolving line of credit. Due to the prepayment of $70,000,000 on our term loan, we expensed a portion of the debt issuance costs on the term loan and recognized a loss from extinguishment of debt of $746,002. On December 11, 2006, we repaid an additional $15,000,000 of the outstanding balance on the term loan. Due to this repayment, we expensed an additional portion of the debt issuance costs on the term loan and recorded a loss from extinguishment of debt of $139,943.

Results of Operations

The following table sets forth certain operating data as a percentage of total revenue for the periods indicated:

	Years Ended December 31,		
	2007	2006	2005
Revenue	100.0%	100.0%	100.0%
Cost of services:			
Compensation expense	47.5%	48.5%	48.0%
Travel and related expenses	7.3%	11.2%	14.4%
Other direct costs	3.8%	4.2%	2.9%
Total cost of services	58.6%	63.9%	65.3%
Gross profit	41.4%	36.1%	34.7%
Operating expenses:			
Salaries and benefits	13.8%	9.1%	9.1%
Other selling, general and administrative expenses	15.3%	8.0%	8.3%
Depreciation and amortization	6.1%	3.2%	2.3%
Amortization of intangibles	6.1%	4.4%	4.9%
Impairment on intangibles	60.8%	0.1%	0.8%
Total operating expenses	102.1%	24.8%	25.4%
(Loss) income from continuing operations	(60.7)%	11.3%	9.3%
Other income	0.0%	0.0%	0.0%
Interest expense, net	2.4%	3.4%	3.9%
Loss from extinguishment of debt	0.1%	0.4%	1.4%
(Loss) income from continuing operations before provision for income taxes	(63.2)%	7.4%	4.0%
Income tax (benefit) expense	(2.8)%	3.0%	1.6%
(Loss) income from continuing operations	(60.4)%	4.4%	2.4%
Loss from discontinued operations	(3.3)%	(1.0)%	0.0%
Net (loss) income	(63.7)%	3.4%	2.4%

Comparison of Years Ended December 31, 2007 and 2006

Revenue

Our consolidated revenue was $152.6 million for fiscal 2007, a decrease of $80.1 million or 34.4%, compared to revenue of $232.7 million for fiscal 2006. The decrease was primarily due to reduced transaction management revenue as a result of the significant decline in non-agency MBS issuance in 2007. Non-agency MBS issuance in 2007 declined by 38% as compared to 2006, and the issuance market deteriorated throughout 2007, with issuance in the fourth quarter declining by 81% as compared to the fourth quarter of 2006. Our revenues also declined throughout 2007, and total revenue in the fourth quarter of $24.8 million declined by 58.5% as compared to the fourth quarter of 2006. The subprime and Alt-A segments of the non-agency MBS market, which have historically been the focus of the Company's transaction management services, nearly stopped all activity by the end of 2007.

The Company's due diligence and conduit revenues are highly dependent on non-agency securitization activity and declined by $70.4 million and $16.7 million, respectively, in 2007 as compared to 2006. These reductions, along with lesser reductions in special servicing, staffing services and compliance services revenues, were partially offset by an increase in surveillance revenue and the

acquisition of Clayton Euro Risk, or CER. Our total revenue per domestic loan increased by 36.7%, as revenues from our non-loan related surveillance and consulting businesses and from CER increased as a percentage of overall revenues. The number of domestic loans serviced during 2007 decreased by 52.6% as compared to fiscal 2006, due to significant reductions in the number of loans serviced in our due diligence and conduit businesses, as a result of the market conditions described above. Revenues per loan in our core due diligence business increased by 1.0% as an increase in non-loan related special due diligence projects involving distressed lenders offset an increase in the percentage of loans serviced in our centralized underwriting facility.

Transaction Management

Transaction management revenue was $97.1 million for fiscal 2007, a decrease of $87.5 million or 47.4%, compared to revenue of $184.6 million for fiscal 2006. The decrease was primarily due to a 52.6% reduction in loans serviced, due to the weak non-conforming mortgage and MBS markets during the period. Our due diligence and conduit revenues are highly dependent on non-agency securitization activity and declined by $70.4 million and $16.7 million, respectively, in 2007 as compared to 2006. Revenue for fiscal 2007 includes a termination fee of approximately $0.5 million in connection with a client's early termination of a contract for conduit support services. We do not expect to generate material revenues from conduit support services in 2008.

Special Servicing

Special servicing revenue was $10.4 million for fiscal 2007, a decrease of $2.7 million or 20.6%, compared to revenue of $13.1 million for fiscal 2006. The decrease was primarily due to the termination of a tax lien servicing contract during the third quarter of 2006, and reduced incentive and monthly fees from our non-performing loan servicing contracts. One contract, which contributed $6.6 million of revenue in 2007, was not renewed for 2008. As a result, special servicing revenue is expected to decline in 2008.

Surveillance

Surveillance revenue was $45.1 million for fiscal 2007, an increase of $10.1 million or 28.9%, compared to revenue of $35.0 million for fiscal 2006. The increase was primarily due to an increase in the value of assets monitored and an increase in our putback review business.

Cost of Services

Our cost of services was $89.5 million for fiscal 2007, a decrease of $59.2 million or 39.8%, compared to cost of services of $148.7 million for fiscal 2006. This decrease was attributable to the specific factors discussed below.

Compensation Expense. Compensation expense was $72.5 million for fiscal 2007, a decrease of $40.4 million or 35.8%, compared to compensation expense of $112.9 million for fiscal 2006. The decrease was primarily due to a reduction in variable contractor expense in our due diligence and conduit businesses due to reduced loan volumes and, to a lesser extent, reduced training, fixed payroll and staffing services contractor expenses.

Travel and Related Expenses. Travel and related expenses were $11.2 million for fiscal 2007, a decrease of $14.9 million or 57.1%, compared to travel and related expenses of $26.1 million for fiscal 2006. The decrease was primarily due to reduced field due diligence loan volumes and staffing services engagements. Travel expenses per loan decreased by 9.8% due to an increase in the percentage of loans serviced in our centralized underwriting facility.

Other Direct Costs. Other direct costs were $5.8 million for fiscal 2007, a decrease of $3.9 million or 40.2%, compared to other direct costs of $9.7 million for fiscal 2006. The decrease was primarily due to reduced third-party appraisal vendor fees due to reduced due diligence volumes.

Operating Expenses

Operating expenses were $155.8 million for fiscal 2007, an increase of $98.0 million, or 170%, compared to operating expenses of $57.8 million for fiscal 2006. This increase was attributable to the specific factors discussed below.

Salaries and Benefits. Salaries and benefits were $21.1 million for fiscal 2007, a decrease of $0.2 million or 0.9%, compared to salaries and benefits of $21.3 million for fiscal 2006. This decrease was primarily due to reduced bonus expense due to the weaker financial results, largely offset by increased information technology compensation expense, severance expense, benefit costs and stock-based compensation expense, due to restricted stock issued during 2007.

Other Selling, General and Administrative Expenses. Other selling, general and administrative expenses were $23.3 million for fiscal 2007, an increase of $4.8 million or 25.9%, as compared to selling, general and administrative expenses of $18.5 million for fiscal 2006. This increase was due to higher occupancy expenses, due to the relocation of the Tampa centralized underwriting operations to a new facility, increased professional fees, bad debt expense, telecommunications and insurance expenses and due to expenses from CER, which was acquired in April 2007. These increases were partially offset by reduced recruiting expenses.

Depreciation and Amortization. Depreciation and amortization was $9.3 million for fiscal 2007, an increase of $1.8 million or 24.0%, compared to depreciation and amortization of $7.5 million for fiscal 2006. This increase was primarily due to depreciation recorded on additional property and equipment and software developed for internal use.

Amortization of Intangibles. Amortization of intangibles was $9.3 million for fiscal 2007, a decrease of $0.9 million or 8.8%, compared to amortization of intangibles of $10.2 million for fiscal 2006. This decrease was primarily due to the impairment of intangibles in the fourth quarter of 2007 as described below. As a result of the impairment, amortization expense is expected to decline significantly in 2008.

Loss on Impairment. Loss on impairment was $92.8 million in fiscal 2007, representing the charge recorded in the quarter ended December 31, 2007 for the impairment of certain goodwill, other intangibles, and software associated with the transaction management segment. Loss on impairment was $0.3 million in fiscal 2006, representing the charge recorded in December 2006 for the impairment of certain customer relationships associated with the special servicing segment.

Interest Expense, net

Interest expense, net was $3.7 million for fiscal 2007, a decrease of $4.3 million or 53.7%, compared to interest expense, net of $8.0 million for fiscal 2006. Interest expense is net of interest income of $0.9 million and $0.5 million for fiscal 2007 and 2006, respectively. This decrease was due to reduced borrowings on our term loan and, to a lesser extent, reduced borrowings on our line of credit and a reduction of the interest rate on the term loan and increased interest income due to higher cash balances during 2007. *See " Liquidity and Capital Resources."*

Loss from Extinguishment of Debt

For fiscal 2007, we recognized a loss from extinguishment of debt of $0.1 million due to the expensing of debt issuance costs as a result of total prepayments of $15.0 million on our term loan during this period. For fiscal 2006, we recognized a loss from extinguishment of debt of $0.9 million due to the expensing of debt issuance costs as a result of total prepayments of $85.0 million on our term loan during this period. *See " Liquidity and Capital Resources."*

Income Taxes

Income taxes for fiscal 2007 were a benefit of $4.3 million, compared to expense of $7.1 million for fiscal 2006. This change was primarily due to changes in taxable income and our effective tax rate. Our effective tax rate for 2007 is not comparable to our effective tax rate of 41.3% for 2006 principally due to the establishment of the valuation allowance that was determined by estimating the recoverability of the deferred tax assets. See note 12 to consolidated financial statements for further discussion of the valuation allowance.

Discontinued Operations

Results for fiscal 2007 include a pre-tax loss on disposal of $5.3 million consisting of a non-cash pre-tax impairment charge of a $4.7 million relating to impairment of goodwill, intangible assets and property and equipment recognized in the first quarter of 2007, and facility closure costs and the write-off of property and equipment during the remainder of 2007 totaling $0.6 million. CLS operating results for fiscal 2007 included revenue of $0.7 million, an operating loss of $2.3 million, a pre-tax loss of $2.4 million, an income tax benefit of $0.8 million and a net loss of $1.6 million. CLS operating results for fiscal 2006 included revenue of $6.5 million, an operating loss of $3.7 million, a pre-tax loss of $3.8 million, an income tax benefit of $1.5 million and a net loss of $2.3 million.

Comparison of Years Ended December 31, 2006 and 2005

Revenue

Our consolidated revenue was $232.7 million for fiscal 2006, an increase of $25.2 million or 12.1%, compared to revenue of $207.5 million for fiscal 2005. The increase was primarily due to an increase in volume in our conduit support services, special servicing and professional staffing services businesses as well as growth in our surveillance services due in part to an increased joint sales effort following the combination of Clayton Fixed Income Services, Inc. (CFIS) and Clayton. Due to growth in our non-loan related services, our total revenues per loan increased 9.2%. The number of loans serviced during 2006 increased 4.0% as compared to fiscal 2005 as growth in our conduit support services offset a reduction in loans serviced in our core due diligence business. Revenues per loan in our core due diligence business were flat during the period as increased revenue per loan from appraisals offset the impact of an increase in the percentage of loans serviced in our central underwriting facility and an increase in the prevalence of other file reviews, in which we verify a limited number of data points in a loan file.

Transaction Management

Transaction management revenue was $184.6 million for fiscal 2006, an increase of $11.2 million or 6.5%, compared to revenue of $173.4 million for fiscal 2005. The increase was primarily due to growth in our conduit support services and professional staffing services businesses. These increases were partially offset by a reduction in revenue from our due diligence business due to a reduction in the number of loans serviced.

Special Servicing

Special servicing revenue was $13.1 million for fiscal 2006, an increase of $4.3 million or 48.9%, compared to revenue of $8.8 million for fiscal 2005. The increase was primarily due to an increase in monthly management and incentive fees from a special servicing contract that commenced during the second half of 2005 and growth in our reverse mortgage servicing operations.

Surveillance

Surveillance revenue was $35.0 million for fiscal 2006, an increase of $9.7 million or 38.3%, compared to revenue of $25.3 million for fiscal 2005. The increase was primarily due to an increase in the value of assets monitored.

Cost of Services

Our cost of services was $148.7 million for fiscal 2006, an increase of $13.2 million or 9.7%, compared to cost of services of $135.5 million for fiscal 2005. This increase was attributable to the specific factors discussed below.

Compensation Expense. Compensation expense was $112.9 million for fiscal 2006, an increase of $13.2 million or 13.2%, compared to compensation expense of $99.7 million for fiscal 2005. The increase was primarily due to the growth in our conduit support services, surveillance services, professional staffing services and special servicing and consulting businesses.

Travel and Related Expenses. Travel and related expenses were $26.1 million for fiscal 2006, a decrease of $3.7 million or 12.4%, compared to travel and related expenses of $29.8 million for fiscal 2005. Travel expenses per loan decreased by 15.7%, as reduced travel expenses per loan in our core due diligence business offset increased travel expense in our non-loan related professional staffing services business. Travel expenses per loan in our core due diligence business declined due to an increase in the percentage of loans serviced in our centralized underwriting facility.

Other Direct Costs. Other direct costs were $9.7 million for fiscal 2006, an increase of $3.7 million or 61.7%, compared to other direct costs of $6.0 million for fiscal 2005. The increase was primarily due to an increase in third-party appraisal fees due to an increase in appraisal revenue in our due diligence business.

Operating Expenses

Operating expenses were $57.8 million for fiscal 2006, an increase of $5.2 million or 9.9%, compared to operating expenses of $52.6 million for fiscal 2005. This increase was attributable to the specific factors discussed below.

Salaries and Benefits. Salaries and benefits were $21.3 million for fiscal 2006, an increase of $2.4 million or 12.7%, compared to salaries and benefits of $18.9 million for fiscal 2005. Salaries and benefits expense for fiscal 2006 included $0.6 million of expense related to the acceleration of vesting of certain stock options as a result of the Company's initial public offering in March 2006. The remaining increase was primarily due to the costs of additional administrative, finance, human resources, technology and executive personnel which were added in preparation for becoming a public company.

Other Selling, General and Administrative Expenses. Other selling, general and administrative expenses were $18.5 million for fiscal 2006, an increase of $1.3 million or 7.6%, as compared to selling, general and administrative expenses of $17.2 million for fiscal 2005. This increase was due to general increases in occupancy, corporate governance, insurance, recruiting, relocation, non-reimbursable travel and telecommunications costs relating to growth in our business, and becoming a public company. These increases were partially offset by reduced consulting expenses and professional fees.

Depreciation and Amortization. Depreciation and amortization was $7.5 million for fiscal 2006, an increase of $2.8 million or 59.6%, compared to depreciation and amortization of $4.7 million for fiscal 2005. This increase was primarily due to depreciation recorded on additional property and equipment and software developed for internal use. These additions were made to enhance our corporate infrastructure and technology platform in support of the growth in business operations and in preparation for becoming a public company.

Amortization of Intangibles. Amortization of intangibles was $10.2 million for fiscal 2006 and fiscal 2005.

Loss on Impairment. Loss on impairment was $0.3 million in fiscal 2006, representing the charge recorded in December 2006 for the impairment of certain customer relationships associated with the special servicing segment. In October 2005, we discontinued the use of the trade name "Murrayhill," and recorded an impairment charge of $1.6 million, affecting the surveillance segment.

Interest Expense, net

Interest expense, net was $8.0 million for fiscal 2006, a decrease of $0.2 million or 2.4%, compared to interest expense, net of $8.2 million for fiscal 2005. This decrease was due to decreased borrowings under our credit facilities primarily due to the prepayment of $70.0 million owed under our senior term loan following our initial public offering in March 2006 and higher interest income, partially offset by increased borrowings outstanding under our credit facilities during the first three months of the year prior to our initial public offering. *See " Liquidity and Capital Resources."*

Loss from Extinguishment of Debt

Loss from extinguishment of debt for fiscal 2006 was $0.9 million due to the expensing of debt issuance costs as a result of $15.0 million prepayment during the fourth quarter of 2006 and a $70.0 million prepayment on our term loan following our initial public offering. Loss from extinguishment of debt was $3.0 million in 2005. In connection with the execution of our new credit agreement in December 2005, we expensed unamortized deferred financing costs and paid prepayment fees related to our previous debt facilities aggregating $3.0 million. *See " Liquidity and Capital Resources."*

Income Taxes

Income taxes for fiscal 2006 were $7.1 million, an increase of $3.9 million, compared to income taxes of $3.2 million for fiscal 2005. This increase was primarily due to changes in taxable income and the effective tax rate. The effective tax rate for 2006 was 41.3% as compared with 38.5% for 2005. This increase was principally due to the establishment of tax reserves and a change in the mix of earnings.

Discontinued Operations

Discontinued operations for fiscal 2006 represent the operating results of CLS which included revenue of $6.5 million, an operating loss of $3.7 million, a pre-tax loss of $3.8 million, an income tax benefit of $1.5 million and a net loss of $2.3 million.

Liquidity and Capital Resources

Historically, we have financed our operations and growth from cash flow from operations and bank borrowings. Due to the continued turmoil in the subprime mortgage loan and securitization markets, and industry projections of lower mortgage loan and securitization activity for 2008 and 2009, we believe the demand for our services, and therefore our revenues, will be lower in the foreseeable future. Based on our anticipated level of transaction volumes and revenues, we believe that funds generated from operations, together with existing cash and available borrowings under our credit agreement, will be sufficient to finance our current operations, planned capital expenditures and new product initiatives through the next twelve months. During the last half of 2007, we instituted a cost reduction program which included workforce reductions and limits regarding discretionary spending in order to scale back expenditures to reflect the decline in our revenues. In addition, we continue to develop new products and services and actively seek new customers for our existing products and services. We believe these actions will mitigate the effect of the downturn in the subprime market on the financial performance of our transaction management business and position us to capitalize on opportunities when the industry recovers and transaction volumes rebound. However, there can be no assurance that these actions will be successful. Should volumes and revenues decline to a level significantly below our current expectations, we would reduce capital expenditures and implement additional cost-reduction initiatives which we believe would be sufficient to ensure that funds generated from operations, together with existing cash and available borrowings under our credit agreement, would be sufficient to finance our current operations through the beginning of 2009.

On February 28, 2006, the Company's Board of Directors approved a 1-for-4 reverse stock split. All share and per share amounts in the accompanying consolidated financial statements have been retroactively adjusted for all periods of the Successor presented, to give effect to the reverse stock split.

Immediately prior to the completion of our initial public offering on March 29, 2006, the following transactions occurred:

- all of our 357,020 outstanding shares of class B common stock converted into 357,020 shares of common stock.
- our series A convertible preferred stock converted into 2,206,308 shares of common stock and 8,825,241 shares of series A redeemable preferred stock.
- our series B convertible preferred stock converted into 6,046,371 shares of common stock and 24,185,493 shares of series B redeemable preferred stock.

Our net proceeds of $131.8 million from our initial public offering, net of $14.8 million of offering expenses and the underwriting discount, were used to:

- redeem $52.8 million of redeemable preferred stock that resulted from the conversion of our Series A convertible preferred stock and Series B convertible preferred stock immediately prior to the completion of the initial public offering.
- repay $70.0 million owed under the senior term loan portion of our credit facility.
- repay $7.4 million owed under the revolving credit portion of our credit facility.
- fund $1.6 million of working capital.

On February 3, 2006, we acquired substantially all of the assets and assumed certain liabilities of CLS (formerly known as Mortgage Resource Network) for an aggregate purchase price and fees aggregating approximately $5.3 million. Working capital was used to fund the acquisition of such assets and assumed liabilities. On March 28, 2007, th