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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

AMBAC ASSURANCE CORPORATION, Plaintiff, - against - EMC MORTGAGE LLC (formerly known as EMC MORTGAGE CORPORATION), J.P. MORGAN SECURITIES LLC, (formerly known as BEAR, STEARNS & CO. INC.), and JPMORGAN CHASE BANK, N.A., Defendants.	Index No. 650421/2011 Hon. Charles E. Ramos **FIRST AMENDED COMPLAINT**

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Plaintiff Ambac Assurance Corporation ("Ambac"), by and through its attorneys, Patterson Belknap Webb & Tyler LLP, for its complaint against defendants EMC Mortgage LLC, formerly known as EMC Mortgage Corporation ("EMC"), Bear Stearns & Co. Inc. ("Bear, Stearns & Co.," together with EMC, "Bear Stearns" and now doing business as J.P. Morgan Securities LLC ("JP Morgan")), and JPMorgan Chase Bank, N.A. ("JPMC Bank") hereby alleges upon personal knowledge as to itself and as to its own conduct and upon information and belief as to all other matters, as follows:

NATURE OF THE ACTION

1. In mid-2006, Bear Stearns induced investors to purchase, and Ambac as a financial guarantor to insure, securities that were backed by a pool of mortgage loans that – in the words of the Bear Stearns deal manager – was a "SACK OF SHIT."[1] Within the walls of its sparkling new office tower, Bear Stearns executives knew this derogatory and distasteful characterization aptly described the transaction. Indeed, Bear Stearns had deliberately and secretly altered its policies and neglected its controls to increase the volume of mortgage loans available for its "securitizations" made in patent disregard for the borrowers' ability to repay those loans. After the market collapse exposed its scheme to sell defective loans to investors through these transactions, JP Morgan executives assumed control over Bear Stearns and implemented an across-the-board strategy to improperly bar EMC from honoring its contractual promises to disclose and repurchase defective loans through a series of deceptive practices. In what amounts to accounting fraud, JP Morgan's bad-faith strategy was designed to avoid and has avoided recognition of the vast off-balance sheet exposure relating to its contractual repurchase

[1] Email from Nicholas Smith (Bear, Stearns & Co. Vice President and Deal Manager) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated August 11, 2006, EMC-AMB 004377399-400 (referring to SACO 2006-8 Transaction as a "SACK OF SHIT [2006-]8" and stating "I hope your [sic] making a lot of money off of this trade.").

obligations – thereby enabling JPMorgan Chase & Co. to manipulate its accounting reserves and allowing its senior executives to continue to reap tens of millions of dollars in compensation following the taxpayer-financed acquisition of Bear Stearns.

2. The securitization transactions at issue here involved the sale by EMC of pools of mortgage loans to trusts, which in turn issued to investors securities that were to be paid down by the promised cash flows from the mortgage loans. As the underwriter and deal manager for the securitizations, Bear, Stearns & Co. solicited rating agencies such as Standard & Poor's and Moody's to rate, bond insurers like Ambac to insure, and investors to purchase the mortgage-backed securities. Bear, Stearns & Co. and EMC acted in concert – under the common control of their parent The Bear Stearns Companies, Inc. – to dupe Ambac and investors to participate in their securitizations. (Thus, Bear, Stearns & Co. and EMC are referred together herein as "Bear Stearns" unless clarification is required.)

3. Specifically, this action arises from Bear Stearns' fraudulent inducement of Ambac and investors to participate in four securitizations, and EMC's extraordinary and material breach of the unambiguous terms and fundamental premise of its agreements governing those transactions, executed between December 2005 and April 2007: the SACO I Trust Series ("SACO") 2005-10, 2006-2, and 2006-8 Transactions, and the Bear Stearns Second Lien Trust ("BSSLT") 2007-1 Transaction (collectively, the "Transactions").

4. In order to induce Ambac's participation, Bear Stearns made representations to Ambac *in advance of the closing* of the Transactions regarding, among other things, (i) the "due diligence" purportedly conducted to prevent defective mortgage loans from entering the securitizations, (ii) the "quality control" processes purportedly implemented to weed out the aberrant defective loan that slipped through the diligence into the securitized pools, (iii) the

protocols Bear Stearns purportedly would follow to "repurchase" any defective loan from the securitizations, and (iv) the "seller monitoring" protocols Bear Stearns purportedly followed to prevent the securitization of loans from suppliers of bad loans. In the parties' agreements *executed in connection with closing*, EMC then made numerous express contractual representations and warranties concerning key attributes of the mortgage loans that backed the securities and the practices of the entities that made those loans, including that the loans were *not* originated through improper means (*e.g.*, fraud or underwriter negligence). EMC also contractually agreed to (a) provide "prompt" notification to Ambac and other deal participants of any loan found to breach its representations and warranties, (b) cure, repurchase, or provide adequate substitutes for breaching loans within 90 days thereafter, and (c) indemnify and reimburse Ambac for any losses caused by such breaches.

5. Bear Stearns knew full well that these representations, going to the very premise of the securitizations, were false and misleading when made. Recently obtained disclosures from Bear Stearns' files have revealed that it secretly adopted certain practices and policies, and abandoned others, to (i) increase its transaction volume by quickly securitizing defective loans before they defaulted, (ii) conceal from Ambac and others the defective loans so it could keep churning out its securitizations, (iii) obtain a double-recovery on the defective loans it securitized, (iv) disregard its obligations to repurchase defective loans, and (v) profit on Ambac's harm.

6. More specifically, Bear Stearns intentionally implemented certain "due diligence" protocols and rejected others to allow it to securitize loans made to borrowers with no ability to repay their loans. To start, Bear Stearns utilized due diligence firms to re-underwrite loans for its securitizations that *it knew* were not screening out loans that were defective and likely to default.

As Bear, Stearns & Co. Senior Managing Director Jeffrey Verschleiser stated in no uncertain terms to fellow Senior Managing Director Michael Nierenberg in March 2006, "[we] are wasting way too much money on Bad Due Diligence."[2] Almost exactly one year later nothing had changed, and in March 2007, Verschleiser reiterated with respect to the *same* due diligence firm that "[w]e are just burning money hiring them."[3] Despite this recognition, Bear Stearns did not change firms or enhance the diligence protocols. Thus, as one of its due diligence consultants frankly admitted, "the vast majority of the time the loans that were rejected were still put in the pool and sold."[4]

7. Moreover, even while criticizing its due diligence firms for failing to adequately detect defective loans, Bear Stearns routinely *overrode* those conclusions and went ahead and purchased and securitized those loans despite material defects that Bear Stearns knew of but failed to disclose (up to ***65% of the time in the third quarter of 2006*** according to one firm's report).[5] Bear Stearns ignored the proposals made by the head of its due diligence department in May 2005 to track the override decisions, and instead took the opposite tack, adopting an internal policy that directed its due diligence managers to delete the communications with its due diligence firms leading to its final loan purchase decisions, thereby eliminating the audit trail.[6] Further still, Bear Stearns elected *not* to implement "significant" changes to its due diligence

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[2] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director) to Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director), among others, dated March 23, 2006, EMC-AMB 001542438-439.

[3] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director) to Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director), among others, dated March 15, 2007, EMC-AMB 005446200.

[4] 8/28/2010 Warren Deposition Tr. at 46. *See* Section III.C.1, below.

[5] Internal Report produced by Clayton Holdings, Inc., CLAY-AMBAC 0001770-80 at 1777 (showing a 65% override rate for EMC and 56% override rate for Bear Stearns in the third quarter of 2006).

[6] 4/21/2010 Mongelluzzo Deposition Tr. at 167-76; 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 318-19.

protocols designed to detect and reject risky loans.[7] In March 2007, for example, the same head of due diligence made a proposal "to completely revamp how we do due diligence," which he conceded was the *same* general proposal he made in May 2005, *but that was never implemented*.[8] This was not happenstance. Bear Stearns disregarded loan quality to appease its trading desk's ever-increasing demand for loans to securitize. In fact, Bear, Stearns & Co. Senior Managing Director Mary Haggerty issued a directive in early 2005 to *reduce* the due diligence "in order to make us more competitive on bids with larger sub-prime sellers."[9]

8. In full recognition that its due diligence protocols did not screen out defective loans and were merely a facade maintained for marketing purposes, Bear Stearns' trading desk needed to quickly transfer the toxic loans from its inventory and into securitizations before the loans defaulted. So as early as 2005, Bear Stearns quietly revised its protocols to allow it to securitize loans before the expiration of the thirty- to ninety-day period following the acquisition of the loans by EMC, referred to as the "early payment default" or "EPD" period. Bear Stearns previously held loans in inventory during the EPD period because, as Bear, Stearns & Co.'s Managing Director Baron Silverstein acknowledged, loans that miss a payment shortly after the loan origination (*i.e.*, within the EPD period) raise "red flags" that the loans never should have been issued in the first instance.[10] The revised policy enhanced Bear Stearns' earnings by increasing the volume of loans it sold into the securitizations – but materially increased the

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[7] 6/4/2010 Silverstein Deposition Tr. at 178.

[8] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President of Due Diligence) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) and Baron Silverstein (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), among others, dated March 6, 2007, EMC-AMB 001431086.

[9] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President of Due Diligence) conveying instructions from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) to reduce due diligence, dated February 11, 2005, EMC-AMB 001718713-14.

[10] 6/4/2010 Silverstein Deposition Tr. at 192.

riskiness of loans sold to the securitizations. Nonetheless, as its executives uniformly conceded, Bear Stearns never once disclosed the changes in its due diligence and securitization policies to investors or financial guarantors such as Ambac.[11]

9. And it gets worse. Not satisfied with the increased fees from the securitizations, Bear Stearns executed a scheme to double its recovery on the defective loans. Thus, when the defective loans it purchased and then sold into securitizations stopped performing during the EPD period, Bear Stearns confidentially (i) made claims against the suppliers from which it purchased the loans (*i.e.*, the "originators" of those loans) for the amount due on the loans, (ii) settled the claims at deep discounts, (iii) pocketed the recoveries, and (iv) left the defective loans in the securitizations. Bear Stearns did not tell the originators of the loans that it did not own, but rather had securitized, the loans as to which it made the claims, and did not tell the securitization participants that it made and settled claims against the suppliers. Nor did it review the loans for breaches of EMC's representations and warranties in response to the "red flags" raised by the EPDs. Bear Stearns thus profited doubly on defective loans it sold into securitizations. Indeed, the increase in loan volume from the securitization of defective loans proved so substantial, and the recoveries secured on those defective loans proved so lucrative that, by the end of 2005, the Bear Stearns' trading desk mandated that all loans were to be securitized before the EPD period expired.[12]

10. Bear Stearns also concealed that its "quality control" and "repurchase" processes were *not* devoted to flushing out and removing breaching loans from the securitized pools, as

[11] *See* Section III.C.2, below.

[12] Email from Chris Scott (Bear, Stearns & Co. Senior Managing Director, Trading) to, among others, Robert Durden (Bear, Stearns & Co. Deal Manager) and Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated January 3, 2006, EMC-AMB 001385832-833; 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 272-73.

Bear Stearns had represented. Rather, the processes were dedicated to securing recoveries against the suppliers of its toxic loans. That is, the quality control and repurchase departments' resources were focused virtually exclusively on (i) identifying grounds for Bear Stearns to make claims against the suppliers of the loans it securitized, and (ii) settling the claims at a discount – without ever notifying the securitization participants of the defective loans it identified or the funds it received. In other words, the quality control department that Bear Stearns touted to Ambac and investors did not provide them with the represented benefits.

11. The secret settlement of the claims on the securitized loans was a win-win for Bear Stearns and its suppliers, but a loss for the securitizations. It was a win for the suppliers in that they settled in confidence all claims with respect to the defective loans at a fraction of the full amount that would have been due had the loans been repurchased from the securitization. Conversely, if they did not comply with Bear Stearns' repurchase demands, Bear Stearns cut off the financing it extended for the origination of additional defective loans.[13] The secret settlement was a win for Bear Stearns, which (i) reinforced its relations with the suppliers that it depended on to provide the precious fodder for future securitizations by settling at the discounted amount, and (ii) pocketed the recovery from the suppliers. It was a loss to the securitization participants, which were not notified of the defective loans in the securitizations and did not receive the benefit from the repurchase of defective loans from the securitizations. Indeed, having settled with originators at a fraction of the outstanding principal and interest due on the loans, Bear

[13] Bear Stearns extended financing to its suppliers that it knew – from its due diligence and quality control processes – were originating defective loans, but cut-off that financing if the supplier defaulted on its settlement agreement with Bear Stearns. *See* Letter from Stephen Golden (EMC Residential Mortgage Corp. President) to SouthStar Funding LLC, dated April 9, 2007, EMC-AMCB1 57571-72; Email from Paul Friedman (Bear, Stearns & Co. Senior Managing Director, Fixed Income) to Jeffrey Mayer (Bear, Stearns & Co. Senior Managing Director and Co-Head of Fixed Income), dated April 18, 2007, EMC-AMB 012043282-283. By agreeing to finance and purchase loans from suppliers of defective loans, Bear Stearns effectively engaged in the origination of defective loans.

Stearns had an economic ***disincentive*** to honor its securitization obligations to identify and repurchase breaching loans from the trusts at the full outstanding amounts due.

12. Ironically, Bear Stearns' scheme worked so well – and resulted in the securitization of so many loans made to borrowers that could not repay – that its quality control and repurchase processes were soon overwhelmed.[14] By late 2005, Bear Stearns' internal audit department caught wind of the "significant backlog for collecting from and submitting claims to sellers," which it then tracked from October 2005 through January 2007.[15] Yet Bear Stearns did not disclose that its lauded repurchase protocols were overwhelmed and were not providing any benefit to the securitizations, and that it was not evaluating whether the defective loans it identified complied with EMC's representations and warranties to the securitization participants.

13. By mid-2006, Bear Stearns' repurchase claims against the suppliers of the loans had risen to alarming levels, prompting warnings from its external auditors and counsel. In a report dated August 31, 2006, the audit firm PriceWaterhouseCoopers advised Bear Stearns that its failure to promptly evaluate whether the defaulting loans breached EMC's representations and warranties to the securitization participants was contrary to "common industry practices, the expectation of investors and . . . the provisions in the [deal documents]."[16] Shortly thereafter, Bear Stearns' internal counsel advised Bear Stearns' management that it was breaching its contractual obligations by failing to contribute to the securitizations the proceeds it recovered

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[14] 4/26/2010 Golden Deposition Tr. at 119; *see* Section III.C.4, below.

[15] Bear Stearns Internal Audit Report, dated February 28, 2006, EMC-AMB 001496305-11 at p. 2; *see* Section III.C.4, below.

[16] *See* "UPB Break Repurchase Project – August 31, 2006," EMC-AMB 006803201-77 at 233

pertaining to the loans in the securitizations.[17] Bear Stearns did not disclose to Ambac either of the findings.

14. Instead of making the requisite disclosures and undertaking the appropriate cures, thereafter Bear Stearns implemented measures to obscure the magnitude of defective loans in its securitizations, and maintain its flow of loans from the suppliers of the defective loans. Thus, Bear Stearns quickly moved to reduce the outstanding claims – to the detriment of the securitizations – by (i) settling the claims at a fraction of the dollar, (ii) waiving the claims entirely, or (iii) deferring (and potentially voiding) the claims by extending the EPD period for securitized loans that defaulted during the initial EPD period, but then resumed payments.[18] Demonstrating the impropriety of its measures, Bear Stearns explicitly directed its employees *not* to extend the EPD period for loans in Bear Stearns' inventory, *i.e.*, not to apply the same rule for loans in its own inventory that it secretly adopted for the securitized loans. According to its Senior Managing Director, Bear Stearns adopted this dual standard because it knew loans that experienced an initial EPD were likely to default again and the "trading desk didn't want to own loans in inventory that had an EPD."[19] Bear Stearns' undisclosed policy thus imposed a risk on the securitizations that its own trading desk would not accept.

15. As a result of these covert measures, Bear Stearns was able to quickly address the backlog of claims, without disclosing or analyzing whether the loans on which it submitted claims breached EMC's representations and warranties to the securitizations. By January 2007, the Bear Stearns internal audit department reported that in 2006 it had resolved "$1.7 billion of

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[17] *See* 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 456-57; 4/26/2010 Golden Deposition Tr. at 39-40.

[18] *See* Section III.C.6, below.

[19] 4/26/2010 Golden Deposition Tr. at 152-53.

claims, an increase of over 227% from the previous year," and that "$2.5 billion in claims were filed, reflecting an increase of 78% from the prior year."[20] The "majority" of the claims pertained to loans with EPDs, *i.e.*, the loans that Bear Stearns acquired without conducting the represented due diligence and conveyed to the securitizations before they defaulted.[21]

16. Bear Stearns followed the same surreptitious practices with respect to the loans in the Transactions. In the disclosures secured to date, Bear Stearns' internal data reveals that it made claims against originators for almost 4,000 loans in the Transactions (with an aggregate original principal balance of $272.7 million) – but repurchased just 237 of those loans from the Transactions.[22] The majority of Bear Stearns claims' were made in 2006 during the height of its double-recovery scheme. The claims then dropped off dramatically in 2007 after Bear Stearns was advised by counsel that it had to relinquish any recoveries on the securitized loans to the Transactions. The claims spiked again in 2009, when as discussed below, JP Morgan began asserting repurchase demands to originators for the breaching loans that Ambac demanded that EMC repurchase – but that Bear Stearns refused to repurchase – from the Transactions. Bear Stearns never gave notice to Ambac or the other Transaction participants of the large-scale defective loans that Bear Stearns itself identified from 2005 through 2007.

17. Yet the magnitude of the defective loans aggregated for its securitizations was starkly evident to the "deal managers" responsible for disclosing the material information concerning the Transactions to potential participants. Thus, the Bear Stearns Vice President who acted as the deal manager for the SACO 2006-8 Transaction referred to the deal in

[20] Bear Stearns Internal Audit Department Escalation Memorandum, dated February 26, 2007, EMC-AMB 010858610-613 at 611.

[21] 4/26/2010 Golden Deposition Tr. at 120-21.

[22] Whole Loan Inventory Tracking System ("WITS") Database, EMC-AMB 002768454; LMS Database, EMC-AMB1 000007558.

correspondence with the trading desk as a "shit breather" and a "SACK OF SHIT."[23] Needless to say, Bear Stearns neglected to mention to Ambac or investors its internal assessments and derogatory characterizations, and did not terminate its securitization.

18. Bear Stearns elected instead to continue to mischaracterize and securitize. Indeed, in early 2007, Bear Stearns publicly purported to "tighten" standards (to adopt policies that should have been in place all along) to buy time while it attempted to clear out its inventory of defective loans. For example, Bear Stearns downgraded certain suppliers of its loans to "suspended" or "terminated" status pursuant to its touted "seller monitoring" protocols, but then directed its quality control personnel ***to stop conducting reviews of those originators' loans*** so it could move the loans out of its inventory and into its securitizations.[24] And, if these loans were not securitized and left in Bear Stearns' inventory, the traders went on tirades, demanding "to know why we are taking losses on 2nd lien loans from 2005 when they could have been securitized?????"[25] Indeed, simultaneous with its hard sell to Ambac regarding its purported efforts to improve underwriting standards of the loans in the BSSLT 2007-1 Transaction executed in April 2007, the Bear Stearns analyst working on the deal more accurately described the deal in internal correspondence as a "going out of business sale."[26] Another called it a

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[23] Remarkably, when his counsel attempted to elicit testimony to explain away these egregious characterizations, the best the Vice President could say is that "shit breather" was a "term of endearment." 6/2/2010 Smith Deposition Tr. at 211-12.

[24] 5/20/2010 Serrano Deposition Tr. at 180-184 (testifying that, over his objections, the President of EMC Residential Corporation, and others, directed the quality control department to stop the review of the suspended and terminated sellers).

[25] Email from Keith Lind (Bear, Stearns & Co. Managing Director, Trading) to Baron Silverstein (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), among others, dated May 8, 2007, EMC-AMB 002283474-476.

[26] Email from Charles Mehl (Bear, Stearns & Co. Analyst, Mortgage Finance) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated April 5, 2007, EMC-AMB 002075468.

"DOG".[27] Both were accurate, yet undisclosed, internal perspectives. Indeed, one of the largest sources of loans in the BSSLT 2007-1 Transaction was SouthStar Funding LLC, an originator that Bear Stearns suspended before the Transaction closed, but stopped its quality control review on those loans so it could move them into the deal and off Bear Stearns' books.

19. Bear Stearns' material misrepresentations and omissions, and false contractual representations and warranties, induced investors to purchase and Ambac to insure securities issued in the Transactions from December 2005 to April 2007.

20. What happened next is now well known: With real estate prices in decline, Bear Stearns and other lenders no longer could extend additional financing to borrowers with no ability to pay so that borrowers could flip their properties to pay off their loans or refinance their loans before they defaulted. The loans that never should have been issued and securitized thus began to default in record numbers. As a result, in the latter part of 2007, the public saw the beginnings of the crisis unfold.

21. In addition to the recently-revealed internal policies and practices that precipitated the Transactions, what was not known until recently was Bear Stearns' (and thereafter JP Morgan's) deliberate misconduct to conceal and avoid accountability for their fraudulent conduct and contractual commitments after the Transactions closed. To start, in late 2007, as the rating agencies began to adjust their ratings of Bear Stearns' mortgage-backed securities, Bear Stearns senior executives – including Senior Managing Director Thomas Marano – attempted to prop up those ratings with threats to withhold "every fee" due to the rating agencies that downgraded the

[27] Email from John Tokarczyk (Bear, Stearns & Co. Associate Director) to Jeffrey Maggard (Bear, Stearns & Co. Managing Director and Deal Manager on the BSSLT 2007-1 Transaction), dated April 30, 2007, EMC-AMB 001469603-604 ("LETS CLOSE THIS DOG").

Bear Stearns securities.[28] Bear Stearns then implemented a policy to conceal the defective loans it identified and thwart the repurchase demands made by Ambac and other securitization participants upon discovery of breaches of EMC's representations and warranties.

22. Despite being advised by its outside auditors and counsel in mid-2006 to review the defective loans it identified for breaches of EMC's representations and warranties, it was not until late 2007, when it could no longer stifle the concern regarding its securities, that Bear Stearns adopted a policy to undertake such review. The belated implementation prompted Bear, Stearns & Co.'s Quality Control Director to note that EMC was for the first time "fully honoring [its] obligations to pro-actively review defective loans for potential PSA [or, securitization] breach."[29] But EMC did *not* thereafter comply with its obligations to provide notice of the breaches it identified, despite direct inquiries and proffers made by Ambac and other securitization participants.

23. By late 2007, Ambac began observing initial signs of performance deterioration in the Transactions, and requested from EMC the loan files for 695 non-performing loans, which were drawn from the three SACO Transactions. When Ambac reviewed the loan files that EMC eventually provided, it discovered widespread breaches of EMC's representations and warranties. Almost 80% of the loans examined, with an aggregate principal balance of approximately $40.8 million across all the Transactions, contained breaches of EMC's

[28] Email from Thomas Marano (Bear, Stearns & Co. Senior Managing Director) to Baron Silverstein (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), among others, dated October 17, 2007, EMC-AMB 001424910-911.

[29] Email from Leslie Rodriguez (EMC Residential Corporation Managing Director) to Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims), dated September 14, 2007, EMC-AMB 006870106-110 at 108. *See also* Email from Fernando Serrano (EMC Mortgage Corporation, Quality Control Manager), dated September 12, 2007 attaching EMC Securitization Breach Quality Control Review protocol, EMC-AMB 011688246-249 at 248 ("Effective in September 2007, all Quality Control Channels . . . are providing to the Securitization Breach team a monthly reporting of all defective loans. This will ensure that going forward all defective loans are reviewed for a securitization breach concurrent with the QC review.").

representations and warranties. Unbeknownst to Ambac until recently, Bear Stearns engaged a consultant to preemptively review the same loan files Ambac requested in late 2007. After an iterative review process between Bear Stearns and its consulting firm to whittle down the breach rate, they still concluded that ***56% of the loans*** were defective.[30] In breach of its clear contractual obligations, EMC did not advise Ambac of its conclusions or provide Ambac or any other securitization participant with "prompt notice" of the breaches identified as it was required to do.

24. Knowing that its fraudulent and breaching conduct was resulting and would continue to result in grave harm to Ambac, Bear Stearns then implemented a trading strategy to profit from Ambac's potential demise by "shorting" banks with large exposure to Ambac-insured securities. (The "shorts" were bets the banks' shares or holdings would decrease in value as Ambac incurred additional harm.) In late 2007, Bear, Stearns & Co. Senior Managing Director Jeffrey Verschleiser boasted that "[a]t the end of October, while presenting to the risk committee on our business I told them that a ***few financial guarantors were vulnerable*** to potential write downs in the CDO and MBS market and ***we should be short*** a multiple of 10 of the shorts I had put on . . . In less than three weeks we made approximately $55 million on just these two trades."[31] Bolstered by this success, Bear Stearns carried this trading strategy into 2008. On February 17, 2008, a Bear Stearns trader told colleagues and Verschleiser, "***I am positive fgic is done and ambac is not far behind***."[32] The next day, in the same email chain, the trader again wrote to Verschleiser to clarify which banks had large exposures to Ambac, asking "***who else***

[30] Loan Disposition Summary (AMB0710) prepared by Clayton Services, Inc. for Bear Stearns, dated November 16, 2007, CLAY-AMBAC 019669.

[31] Email from Verschleiser, dated November 20, 2007, EMC-AMB 009600760-63.

[32] Email from Adam Siegel (Bear Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), dated February 17, 2008, EMC-AMB 012117052-063.

has big fgic or abk [Ambac] exposures besides soc gen?"[33] As it was "shorting" the banks holding Ambac-insured securities, Bear Stearns continued to conceal the defects it discovered and deny Ambac's repurchase demands relating to collateral that back the securities issued in the Transaction.

25. The senior management of Bear Stearns allowed the foregoing misconduct to occur, and failed to implement the controls required to prevent such abuses, because they were making tens of millions of dollars churning out securitizations replete with loans that never should have been made, and that were only made because Bear Stearns provided the means to convert those loans into securities for sale to investors. Because Bear Stearns was a public company, and they were "playing with other people's money," the Bear Stearns executives disregarded the long-term implications of their conduct to generate the short-term earnings that funded their extraordinary compensation packages. This textbook example of unmitigated and realized "moral hazard" risk has wreaked unprecedented harm on (i) the borrowers that have defaulted in droves and lost their homes because they were put into loans they could not afford, (ii) the investors that purchased the securities issued in the Bear Stearns transactions, (iii) Ambac as a financial guarantor of the payments due to the investors, (iv) Bear Stearns' own shareholders, and (v) the national, and indeed global, economy. The senior management of JP Morgan made matters even worse when, in early 2008, they assumed control of EMC and Bear, Stearns, & Co.

26. With EMC's liabilities now consolidated into the JPMorgan Chase & Co. financials, JP Morgan implemented a bad-faith strategy to deny Ambac's legitimate repurchase demands to EMC – even in those instances where JP Morgan concluded that EMC would be

[33] Email from Adam Siegel (Bear Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), to Verschleiser, among others, dated February 18, 2008, EMC-AMB 012117048-051.

liable for breach of contract. JP Morgan caused EMC to reject legitimate repurchase demands by Ambac, as well as other financial guaranty insurers, to understate materially the accounting reserves JPMorgan Chase & Co. was required to accrue and disclose in its financial statements to reflect the liability inherited from EMC for repurchase obligations associated with defective loans. JP Morgan thus interfered with EMC's contractual obligations to Ambac (and other insurers) to assist its parent corporation, JP Morgan Chase, effectuate a massive accounting fraud. JP Morgan interfered fraudulently, and deceptively represented to Ambac that the rejections of Ambac's repurchase demands were based on the reasons set forth in the written responses to the demands. In fact, JP Morgan itself had concluded, and knew that EMC and Bear Stearns & Co. (prior to JP Morgan taking control of Bear Stearns & Co.) previously had concluded, that the bases for the repurchase demands for a substantial portion of challenged loans were well founded. Indeed, in a number of instances, EMC had made repurchase demands on the originators of the loans for the very same reason(s) Ambac cited in support of its repurchase demands to EMC.

27. Thus, *within just days* of assuming control of Bear Stearns' repurchase review process, a JP Morgan Executive Director, with no prior knowledge of the deals, arbitrarily rejected half of Bear Stearns' affirmative breach findings that included several loans from the Transactions, and in one stroke eliminated up to $14 million in liabilities, thereby achieving the intended purpose of reducing the accounting reserves for those loans by almost 50%.[34] In addition, with respect to the loans that Ambac requested EMC to repurchase in April and May 2008 (*see supra* ¶ 23), JP Morgan executives deliberately disregarded that Bear Stearns itself had

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[34] Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Alison Malkin (J.P. Morgan Securities, Inc. Executive Director, Securitized Products), who was responsible for the "re-review" of Bear Stearns prior breach designations, dated May 05, 2008, EMC-AMB 007173918-919.

identified widespread breaches ***in the very same loan sample*** in its covert review undertaken in late 2007 before JP Morgan's interference. Instead, responding on behalf of EMC, JP Morgan rejected virtually every one of the 526 loans that Ambac identified as being in breach.[35]

27. Moreover, even while refusing to repurchase breaching loans that Ambac identified and requested, the same JP Morgan executive implemented a policy of demanding that suppliers repurchase *from* EMC the *same* loans, for the *same* reasons that Ambac and other financial guarantors had requested EMC to repurchase.[36] JP Morgan rebuffed Ambac's repurchase requests even where Bear Stearns had previously demanded that originators repurchase the exact same loans because the same or similar defects subsequently identified by Ambac.[37] The duplicitous and deceptive conduct is patent and the motivation clear: JP Morgan adopted a strategy to deliberately and systematically deny the financial guarantors' legitimate repurchase demands to avoid JPMorgan Chase & Co. from bringing onto its financial statements the massive off-balance sheet exposure and, in doing so, effectively engaged in accounting fraud.

28. Ambac's on-going analyses of the loans in the Transactions have affirmed JP Morgan's malfeasance, and Bear Stearns' internal derogatory characterization of the loan pools leading up to the Transactions. After conducting the initial review noted above, Ambac reviewed a random sample of 1,482 loans, with an aggregate principal balance of approximately $88.2 million, selected across all four Transactions. The results of that review are remarkable. Of these 1,482 loans, 1,351, or over 91%, breached one or more of the representations and warranties that EMC had made to Ambac. As of June 2010, Ambac's loan-level review consisted of 6,309 loans, of which it identified 5,724 loans across the Transactions that breached

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[35] EMC "agreed" to repurchase just nine loans out of the sample reviewed, but has not done so.

[36] *See* Section III.F, below.

[37] *Id.*

one or more of EMC's representations and warranties. Bear Stearns (now JP Morgan) – acting with authority to perform EMC's obligations under the Transactions – has to date "agreed" to repurchase only 52 loans, or less than 1%, of those breaching loans, but has in fact not repurchased a single one.[38]

29. The most prevalent breaches identified by Ambac are also the most troubling and involve: (i) rampant misrepresentations about borrower income, employment, assets, and intentions to occupy the purchased properties, and (ii) the loan originators' abject failures to adhere to proper and prudent mortgage-lending practices, including their own underwriting guidelines. The pervasiveness of these breaches has subsequently been confirmed by EMC's recent disclosures of its internal quality control and claims documentation and data, as well as the dramatic testimony of the borrowers of those loans.[39]

30. Loss and delinquency patterns experienced by the Transactions have also been consistent with these revelations. The loans that Bear Stearns securitized have defaulted at an extraordinary rate, depriving the Transactions of the cash flows required to pay down the respective securities and, thereby, requiring Ambac to make enormous payments with respect to its insurance policies. The four Transactions have together suffered more than $1.2 billion in losses, resulting in more than $641 million in total claims paid by Ambac.

31. Bear Stearns' material misrepresentations, omissions and breaches of the parties' agreements fundamentally altered and essentially gutted the parties' bargain, the nature of the Transactions, and the value of and interests in the securitized loans. Bear Stearns has thereby inflicted and is inflicting tremendous harm on Ambac and the investors Ambac insures. Ambac

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[38] *See* Section VI.A, below.

[39] *See* Sections VI.B, & C, respectively, below.

is therefore entitled to be made whole and to be placed in the position that it would have been in had it never entered into any of the Transactions.

I. THE PARTIES

A. PLAINTIFF

32. Ambac is a Wisconsin corporation with its principal place of business at One State Street Plaza, New York, New York 10004. Based in large part on the economic harm it has suffered as a result of Defendants' misconduct, Ambac has been involved in rehabilitation proceedings under Wisconsin insurance law. In connection with those proceedings, on March 24, 2010, Ambac established a segregated account (the "Segregated Account") pursuant to Wisconsin Statute Section 611.24, with the approval of the Office of the Commissioner of Insurance of the State of Wisconsin (the "Commissioner"). On the same date and upon the Verified Petition of the Commissioner, the Circuit Court for Dane County, Wisconsin, placed the Segregated Account into statutory rehabilitation under Wisconsin Statute Sections 645.31 and 645.32 on March 24, 2010. Ambac allocated the policies at issue in this action to the Segregated Account pursuant to the Plan of Operation for the Segregated Account.

B. THE "BEAR STEARNS" DEFENDANTS

33. EMC is organized under the laws of the State of Delaware and its principal place of business is at 2780 Lake Vista Drive, Lewisville, Texas 75067. At all relevant times leading up to, and including, when the Transactions were effectuated, EMC was a wholly owned subsidiary corporation of The Bear Stearns Companies Inc. ("The Bear Stearns Companies") and an affiliate of the depositor and underwriter in the Transactions. Pursuant to a merger agreement effective May 30, 2008, JPMorgan Chase & Co. acquired the assets and operations of The Bear Stearns Companies Inc., including Bear, Stearns & Co. and EMC, for nominal consideration in a transaction that was financed in part by a $29 billion non-recourse loan made by taxpayers (the

"Merger"). After the Merger, EMC is wholly owned by The Bear Stearns Companies, LLC, which in turn is wholly owned by JPMorgan Chase & Co.[40] On or about March 31, 2011, EMC underwent a change in form from a corporation to a limited liability company, and it now is registered in Delaware as EMC Mortgage LLC.

34. Bear, Stearns & Co. was an SEC-registered broker-dealer and a wholly-owned subsidiary of The Bear Stearns Companies Inc., principally located at 383 Madison Avenue, New York, NY 10179. Bear, Stearns & Co. served as the underwriter for all of the Transactions. Following the Merger, on or about October 1, 2008, Bear, Stearns & Co. merged with an existing subsidiary of JPMorgan Chase & Co. known as J.P. Morgan Securities Inc., and the resulting entity is now doing business as J.P. Morgan Securities Inc. Effective September 1, 2010, JP Morgan Securities Inc. converted from a corporation to a limited liability company, and changed its name to J.P. Morgan Securities LLC (defined above as "JP Morgan"). Accordingly, all allegations against Bear, Stearns & Co. are made against its legal successor, JP Morgan.

35. JP Morgan is a wholly owned subsidiary of JPMorgan Chase & Co., which is an investment banking holding company incorporated in Delaware and principally located at 270 Park Avenue, New York, NY, 10016.

36. JPMC Bank is a national banking association whose articles of association designate Columbus, Ohio as the location of its main office, and whose principal place of business is in New York, New York. JPMC Bank acquired all or substantially all of EMC's assets and succeeded to EMC's business on or about April 1, 2011. JPMC Bank and EMC are both wholly owned by JPMorgan Chase & Co. JPMC Bank and EMC are affiliated entities that shared common ownership before the Asset Transfer and continue to share common ownership

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[40] EMC's 7.1 Disclosure Statement filed January 20, 2009.

after the Asset Transfer. As explained more fully below, JPMC Bank is a successor to EMC and is therefore liable for the conduct of EMC alleged herein.

II. JURISDICTION, VENUE AND PRIOR PROCEEDINGS

37. This Court has personal jurisdiction over the defendants pursuant to N.Y. C.P.L.R. §§ 301, 302, 311, and 311-a.

38. Venue is proper in New York County pursuant to N.Y. C.P.L.R. §§ 503(a), 503(c), and 503(d).

39. Further, in its Insurance and Indemnity Agreement ("I&I Agreement") with Ambac for each Transaction, EMC irrevocably submitted to the "non-exclusive jurisdiction of . . . any court in the State of New York located in the City and County of New York."[41] In addition, in each I&I Agreement, EMC "waive[d] and agree[d] not to assert by way of motion, as a defense or otherwise in any such suit, action or proceeding, any claim that it is not personally subject to the jurisdiction of such courts, that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that the related documents or the subject matter thereof may not be litigated in or by such courts."[42]

40. Defendant Bear, Stearns & Co. (now known as JP Morgan) also is subject to personal jurisdiction in this Court because it is authorized to do business within New York and regularly transacts business within the State.

41. Defendant JPMC Bank is subject to personal jurisdiction in this Court because it is authorized to do business within New York, has offices within the State, and regularly transacts business within the State.

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[41] *See, e.g.*, I&I Agreement § 6.05(a) (for each Transaction).

[42] *Id.*

42. Defendants EMC and Bear, Stearns & Co. participated in negotiations and other activities within the State that led to the Transactions that give rise to the claims in this complaint, and the Transactions themselves occurred within the State.

43. Defendants EMC and Bear, Stearns & Co. also submitted to jurisdiction in New York State while this matter was pending in the Southern District of New York, *Ambac Assurance Corp. v. EMC Mortgage Corp.*, Civil Action No. 08 CV 9464 (RMB) (THK). In November 2008, Ambac commenced a breach-of-contract action against EMC in federal court in New York, with subject matter jurisdiction based on the diversity of the parties. After securing discovery of Bear Stearns' files, Ambac moved to amend its complaint to assert additional claims and join Bear, Stearns & Co. (now JP Morgan) as a defendant. In granting that motion, the federal district court repeatedly ruled – initially in a report and recommendation, on reconsideration, and finally on appeal to the district judge – that Ambac is entitled to pursue a common-law claim for fraudulent inducement against both EMC and Bear, Stearns & Co. based on the sufficiency of the allegations as pleaded herein. The federal court also concluded that the joinder of Bear, Stearns & Co. was consistent with principles of fundamental fairness even though it would destroy diversity jurisdiction and require Ambac to re-file its amended complaint in this Court. The district court declined to rule on the viability of Ambac's tortious interference claim, which it left for this Court to determine.

III. BACKGROUND

A. THE BEAR STEARNS MORTGAGE LOAN SECURITIZATION "MACHINE"

44. This action arises from the materially false and misleading disclosures and representations and warranties made by Bear Stearns in connection with the securitization of mortgage loans in four Transactions executed in December 2005, January 2006, September

2006, and April 2007. Each Transaction involved the pooling and sale of mortgage loans to a trust. The trusts issued debt securities of varying seniority, whose payments to investors were dependent on, or "backed" by, the cash flow received from the mortgage payments on the pooled loans. The four Transactions were among hundreds that the Bear Stearns securitization machine churned out from 2005 to 2007.

1. Bear Stearns Controlled Every Aspect of the Securitization Process

45. Through its well-engineered network of affiliates, Bear Stearns controlled every link in the mortgage-loan-securitization chain, including (i) the origination, and financing of the origination, of loans that provided the cash flow for the mortgage-backed securities, (ii) the "warehousing" or temporary financing of large pools of loans pending their pooling and securitization into mortgage-backed securities, (iii) the underwriting, offering, and sale of the mortgage-backed securities, included to funds managed by its affiliates, and (iv) the servicing of loan pools to ensure the continued payment of principal and interest needed to make payments under the mortgage-backed securities. As Bear Stearns' parent, The Bear Stearns Companies, reported in its 2006 Annual Report, this "vertically integrated franchise allows us access to every step of the mortgage process, including origination, securitization, distribution and servicing."[43] Bear Stearns and the affiliates that implemented each of these components of the mortgage-securitization process were directed and controlled by the senior executives and traders sitting in New York, and shared common board members, executives, systems, and resources.[44]

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[43] The Bear Stearns Companies Inc., 2006 Annual Report, at 11 (2007).

[44] 4/26/2010 Golden Deposition Tr. at 12-13, 52-53 (stating that the "reporting relationship was to New York" and noting that approximately 50 to 60 individuals had dual titles at Bear Stearns and an EMC entity); 12/11/ 2009 Durden Rule 30(b)(6) Deposition Tr. at 45; 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 71-73; 4/15/2010 Gray Deposition Tr. at 48; 5/28/2010 Sears Deposition Tr. at 247-48.

46. Bear Stearns used the offices of EMC in Texas to house its mortgage-loan "conduit" that generated the flow of loans into the securitization pipeline from which the mortgaged-backed securities issued.[45] Mary Haggerty, who was the Senior Managing Director responsible for the conduit's creation in 2001, explained that the EMC conduit acquired mortgage loans for securitization and not to hold in inventory: "[I]f you think of a pipe, water comes in and water goes out as opposed to a pipe leading to a reservoir that's going to be held."[46] EMC thus supplied the Bear Stearns securitization machine with mortgage loans that Bear Stearns had no intention of ever holding, and indeed was loathe to hold, in its own inventory.

47. EMC guided the flow of loans through the pipeline by (i) acquiring and aggregating the mortgage loans to be securitized, (ii) sponsoring the securitizations by selling loan pools to the trusts that issued the securities, and (iii) acting as "servicer" for a large number of the securitized loans, with, among other things, the obligation to collect amounts from the borrowers for the benefit of the trusts. Moreover, as discussed in detail below, EMC also purported to undertake pre- and post-acquisitions reviews and implement other controls to ensure the quality of the loans acquired.

48. The majority of loans EMC acquired for securitization were purchased from large third-party originators, such as American Home Mortgage Investment Corp., SouthStar Funding, LLC ("SouthStar"), SunTrust Mortgage, Inc., Impac Funding Corporation, Just Mortgage, Inc. ("Just Mortgage"), and GreenPoint Mortgage Funding, Inc. ("GreenPoint"). Bear Stearns and its

[45] 4/19/2010 Glory Deposition Tr. at 93-95 (Bear Stearns Managing Director testified that references to the "Bear Stearns Subprime Mortgage Conduit" meant the conduit housed at EMC); EMC Investor Presentation dated July 26, 2006, EMC-AMB 010838314-413 at 315(EMC's conduit operations were headquartered in Dallas, Texas).

[46] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 21.

affiliates extended financing within its originator network,[47] which offered an advance line of funds available to originators to maintain the constant stream of loans acquired by EMC for securitization.[48] Indeed, in the same correspondence offering financing, Bear Stearns reminded the originators that it would pay premium pricing on any loans originated and sold to EMC.[49] Because the originators were not lending their own funds, Bear Stearns encouraged and enabled them to originate a continuous flow of defective loans. Bear Stearns thus provided the means by which these originators approved and generated thousands of mortgages in total disregard of borrowers' ability to repay their debts and which it knew – from due diligence, conducted by third-party firms such as Clayton, and its quality control – violated state laws, including deceptive trade practices and anti-predatory lending laws, such as those requiring that the loan or refinancing must be in the borrowers' best interests.[50]

49. EMC also obtained loans for securitization from its originator affiliates Bear Stearns Residential Mortgage Corporation ("BSRM") and EMC Residential Corporation

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[47] Bear Stearns Mortgage Capital Corporation was the warehouse financing facility for Bear Stearns' bulk acquisition channel; EMC Residential housed the warehouse financing facility for loans acquired through the flow acquisition channel. 6/4/2010 Silverstein Deposition Tr. at 93-94; *see also* 4/15/2010 Gray Deposition Tr. at 11-14 (EMC Residential was a warehouse lender that provided funds to correspondent lenders of mortgage loans).

[48] For example, internal EMC documents show that as of May 2005, SouthStar's credit limit with EMC Residential Warehouse Group was increased to $375 million on May 19, 2005 (EMC-AMB 010940606-47, at 631), and remained a "warehouse client" through March 2007 (EMC-AMB 006783646-48). Similarly, Bear Stearns extended credit to Just Mortgage exceeding $65 million between September 28, 2005 and December 22, 2006 (EMC-AMB 010940606-47 at 626). *See also* 6/4/2010 Silverstein Deposition Tr. at 90-94 (confirming that American Home and Impac received financing); 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 249-53 (discussing an e-mail that confirms that SouthStar received financing).

[49] Email from Norman Scott (Bear, Stearns & Co. Inc. Vice President and Product Manager) to CPMC, dated April 4, 2005, EMC-AMB 001254436-437 at 437 ("Bear Stearns have [sic] substantially expanded our Alt-A and Sub Prime product offering and are offering premium pricing for product that is sent to the warehouse facility and purchased by EMC.").

[50] In response to an investigation by the Attorney General of Massachusetts, another investment bank which engaged in similar practices as alleged herein agreed to pay the state $102 million. See Assurance of Discontinuance, In re Morgan Stanley & Co. Inc., No. 10-2538 (Super. Ct. Mass. June 24, 2010).

("EMCRC").[51] From its originator network, BSRM and EMCRC, Bear Stearns generated an enormous volume of residential mortgage loans that it financed, purchased and originated, "with the ultimate strategy of securitization into an array of Bear Stearns' securitizations."[52] Bear Stearns leveraged its multiple roles and affiliates to dictate loan-origination standards for the loans it securitized, either by requiring that loans be originated to its published guidelines or by approving the guidelines used by its larger originators, with whatever changes Bear Stearns believed were necessary.[53] But, Bear Stearns abandoned the protocols necessary to ensure adherence to those guidelines.

50. Bear, Stearns & Co., for its part, acted as lead underwriter and designated its employees as the deal managers to broker the EMC-sponsored securities offerings. It solicited the rating agencies to rate, financial guarantors such as Ambac to insure, and investors to purchase these mortgage-backed securities.[54] Thus, Bear, Stearns & Co. (i) worked with EMC to structure the Transactions,[55] (ii) took the lead in coordinating the flow of documents and information among the rating agencies and parties to the Transactions, (iii) purchased the

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[51] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 41-42 (Bear Stearns Residential Mortgage Corporation was a wholesale lender that commenced operations in 2005; its assets were sold to Loan Star funds in May 2008).

[52] *See* Prospectus Supplement ("ProSupp") for SACO 2006-8 Transaction, dated Sept. 14, 2006 ("SACO 2006-8 ProSupp"), at S-29.

[53] Bear Stearns Subprime Mortgage Conduit and EMC Servicing Investor Presentation, EMC-AMB 001421565-597 at 572, 576 (noting process to "approve seller underwriting guidelines."). *See also* 4/26/2010 Golden Deposition Tr. at 54-55 ("[O]n the origination side, I guess we set the – the limits and the type of product that sellers could sell to EMC.").

[54] 4/19/2010 Glory Deposition Tr. at 49-55, 57-59 (testimony regarding EMC and Bear Stearns roles).

[55] *See*, *e.g.*, ProSupp for SACO 2006-2 Transaction, dated January 26, 2006 ("SACO 2006-2 ProSupp"), at S-39 ("Subsequent to purchase by the sponsor, performing loans are pooled together . . . with the assistance of Bear Stearns' Financial Analytics and Structured Transactions group, for distribution into the primary market."); *see also* SACO 2006-8 ProSupp at S-29; ProSupp for BSSLT 2007-1 (Group I) Transaction, dated April 30, 2007 ("BSSLT 2007-1 (Group I) ProSupp"), at S-35, and ProSupp for BSSLT 2007-1 (Groups II & III) Transaction, dated April 30, 2007 ("BSSLT 2007-1 (Groups II & III) ProSupp"), at S-47.

mortgage-backed securities issued in the Transactions (the "Notes") on a firm commitment basis pursuant to written agreements with the Depositor,[56] and (iv) offered and sold the Notes to investors.[57] The Bear, Stearns & Co. trading organization – reporting to Tom Marano – also made the decisions on the volume of securitizations to effectuate, and, likewise, the volume of loans being acquired by the conduit was "highly controlled by the trading desk."[58] And, as discussed further below, Bear, Stearns & Co. executives made decisions regarding the due diligence, quality control, and repurchase protocols to be followed (or not followed) by EMC in relation to the securitized loans.

51. Bear Stearns' affiliates also frequently purchased or retained a financial interest in a portion of the securities issued in these transactions, which it often repackaged into securities known as "collateralized debt obligations" ("CDOs"). Moreover, then a Senior Managing Director of Bear, Stearns & Co., Ralph Cioffi helped create both the supply and demand for the securitizations, soliciting insurers and investors to participate in its transactions, and then purchasing the securities issued for the investment funds he managed through Bear Stearns affiliates, including Bear Stearns Asset Management. Finally, Bear Stearns provided financial research for residential mortgage-backed securities and related structured products that it created and sold.

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[56] For example, in the SACO 2005-10 Transaction, Bear, Stearns & Co. and the Depositor, Bear Stearns Asset Backed Securities I LLC, entered into an Underwriting Agreement, dated December 12, 2005, and Terms Agreement, dated December 20, 2005, providing that: "Underwriter agrees, subject to the terms and provisions of the above-referenced Underwriting Agreement, which is incorporated herein in its entirety and made a part hereof, to purchase the respective principal amounts of the Classes of the above-referenced Series of Certificates as set forth herein." Bear, Stearns & Co. and the Depositor entered into similar Underwriting Agreements and Terms Agreements in the SACO 2006-2, SACO 2006-8, and BSSLT 2007-1 Transactions with virtually identical language.

[57] The Underwriting Agreements further provide: "It is understood that each Underwriter proposes to offer and/or solicit offers for the Certificates to be purchased by it for sale to the public as set forth in the Prospectus . . . ."

[58] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 86-87.

52. Through Bear Stearns, The Bear Stearns Companies recorded gains and earned fees at every step in this chain: (i) loan-origination fees, (ii) gains on sale of the mortgages to the securitization trusts, (iii) fees from underwriting mortgage-backed securities, (iv) fees from servicing of the securitized loans, (v) fees from CDOs into which these securities were repackaged, (vi) gains and fees from trading in these securities and interests in the CDOs into which they were placed, and (vii) management fees and carried interests from hedge funds and other investment vehicles that invested in the vast array of securities and financial products structured by Bear Stearns and its affiliates that ultimately were backed by residential mortgage loans.

53. As discussed below, the greatest benefit from these fees flowed to the senior executives and traders, who obtained obscene compensation by putting at risk Bear Stearns' ongoing wherewithal.

2. Bear Stearns Churned Out Securitizations by Sacrificing Loan Quality

54. At the time the Transactions at issue in this litigation were consummated, The Bear Stearns Companies had long been a leader in all facets of mortgage-loan securitization, at or near the top of the charts for issuance and underwriting of mortgage-backed securities for 17 years running.[59] The Bear Stearns Companies built this once-stellar reputation on the securitization of large, high-quality loans referred to as "jumbo prime," which was the business it maintained until 2001.[60]

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[59] *See, e.g.*, Asset-Backed Alert, Dec. 31, 2006, *available at:* http://www.abalert.com/Public/MarketPlace/Ranking/index.cfm?files=disp&article_id=1044674725 (ranking Bear Stearns as the fifth-largest issuer of mortgage-backed securities); Q4 2006 The Bear Stearns Companies Earnings Conference Call, Dec. 14, 2006 (stating that, for 2006, "Bear Stearns ranked as the number one underwriter of MBS Securities [mortgage-backed securities] as the Company's securitization volume rose to $113 billion from $95 billion in fiscal 2005, capturing 11% of the overall U.S. mortgage securities market").

[60] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 28, 30.

55. But The Bear Stearns Companies then formed the mortgage-loan conduit at EMC that effectuated the Transactions at issue. The new conduit initially focused on the securitization of "Alt-A" loans, which were made to borrowers that were generally considered more risky than prime borrowers. The profits from the securitizations grew year after year, but took off in 2003, when Bear Stearns began to securitize "subprime" mortgage loans, which it never squarely defines, but that generally constitute loans issued to borrowers with limited incomes or relatively low FICO credit scores due to poor credit history.[61]

56. From 2003 to 2006, The Bear Stearns Companies' revenue and profit increased by 123.8% and 77.6%, respectively, driven in large part by mortgage finance and its securitization machine.[62] For 2006, The Bear Stearns Companies' overall securitization volume rose to $113 billion from $95 billion in fiscal 2005, amounting to 11% of the overall U.S. mortgage-securities market.[63] Consistently, the volume of EMC's securitizations grew markedly over the same period. In 2003, EMC securitized 86,000 loans valued at approximately $20 billion. That number nearly tripled in 2004 to 230,000 loans valued at $48 billion.[64] In 2005, the number jumped to 389,000 loans valued at nearly $75 billion.[65] And in 2006, EMC securitized

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[61] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 32-33 (EMC began purchasing subprime loans for securitization); *see also* 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 29-30 (unable to provide a definition distinguishing Alt-A loans from subprime); 4/15/2010 Glory Deposition Tr. at 178-79 (testifying she had no knowledge of whether the definition of subprime changed over time); 5/28/2010 Sears Deposition Tr. at 36-37 (defining a subprime loan as one given to a borrower with "less than pristine" credit history); 6/2/2010 Smith Deposition Tr. at 93 ("I don't believe there was a definition [of subprime]").

[62] The Bear Stearns Companies Inc., Annual Report (Form 10-K), at 79 (Nov. 30, 2006); The Bear Stearns Companies Inc., Annual Report (Form 10-K), at 77 (Nov. 30, 2005).

[63] Q4 2006 Bear Stearns Earnings Conference Call, Dec. 14, 2006.

[64] SACO 2006-8 ProSupp at S-29.

[65] SACO 2006-8 ProSupp at S-29.

over 345,000 loans valued at $69 billion.[66] All told, from 2003 to 2007, EMC purchased and securitized more than one million mortgage loans originally valued in excess of $212 billion.[67]

57. Bear Stearns achieved the dramatic growth in its securitization volume by (i) obtaining an ever-increasing supply of mortgage loans for its securitizations, while (ii) maintaining the demand for the securities backed by those loans.

58. Having already moved from the prime into the Alt A and subprime markets, Bear Stearns further extended the reach of its mortgage portfolio by expanding its use of "reduced documentation" or "no documentation" loan programs. While these programs bear various names (*e.g.*, "Stated Income," "No Ratio," "Stated Income Stated Asset," or "SISA"), they share the common characteristic of requiring less documentation from the borrower than traditional full-documentation loan programs. Accordingly, the reduced- or no-documentation programs were designed to be offered only to certain types of pre-qualified borrowers (*e.g.*, self-employed individuals with very strong credit and substantial equity in the mortgaged property), and the originators supplying the loans were required to use alternative means of assessing the borrowers' ability to repay the loans. However, over time, Bear Stearns and its stable of originators expanded these programs to riskier categories of borrowers in order to increase loan volume.

59. In addition to the expanded use of the reduced-documentation programs, to keep the pipeline full, EMC added second-lien loans and home-equity lines of credit ("HELOCs") to its portfolio of mortgage products. HELOCs, which are among the loans securitized in two of the Transactions, provide borrowers with a revolving line of credit that is generally secured by a secondary lien on the property. EMC's HELOC business began in 2005 with over 9,300

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[66] BSSLT 2007-1 (Group I) ProSupp at S-35.

[67] BSSLT 2007-1 (Group I) ProSupp at S-35.

HELOCs valued at more than $509 million and grew to more than 18,000 HELOCs valued at over $1.2 billion by the end of 2006.[68] The growth in its second-lien business was meteoric, with volume skyrocketing from approximately 15,000 loans valued at approximately $660 million at the end of 2004 to approximately 116,500 loans valued at approximately $6.7 billion at the end of 2006.[69]

60. The reduced-documentation programs and second-lien products Bear Stearns exploited had been in use in residential mortgage lending for some time, and were not at the time considered problematic in and of themselves. Rather, the programs and products were appropriate sources of loans *so long as* commensurate controls were implemented and followed to ensure the quality of the securitized loans.

61. As discussed in detail below, Bear Stearns made extensive representations in advance of and at the closing of its securitizations to convince investors and financial guarantors, including Ambac, that it had implemented and was applying the controls required to ensure the quality of these loans. The Bear Stearns Companies underscored the commitment to loan quality to assuage any concerns regarding the pace of its growth:

> [O]ur [origination and] conduit business . . . saw a significant increase in origination volume over the course of the year and that's important not only because it secures a direct pipeline of product for securitization and thereby allows us to maintain and increase share, but also it has a lot to do with the quality of the product that we're able to put out in the nonagency space.[70]

62. The Bear Stearns Companies' pitch was persuasive and worked. Bear Stearns' representations induced Ambac to insure payments due on securities issued from its securitization pipeline, and induced investors to purchase those securities.

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[68] BSSLT 2007-1 (Group I) ProSupp at S-35.

[69] BSSLT 2007-1 (Group I) ProSupp at S-35.

[70] The Bear Stearns Companies Investor Conference Call regarding Q4 2005 Earnings, Dec. 15, 2005.

63. But, Bear Stearns did not take steps to ensure the "quality of the product." Quite to the contrary, Bear Stearns pushed for increased loan volumes and expanded its securitization of these products at the expense of underwriting standards.[71] As a consequence, EMC's inventory of mortgage loans was replete with loans (i) originated by fraud, material misrepresentations, or omissions and (ii) underwritten without regard to prudent standards or the fundamental principles of mortgage lending, which require a good-faith assessment of borrowers' ability and willingness to repay the loan.

64. By abandoning appropriate underwriting and due diligence to increase loan volume, Bear Stearns conveyed to each of the Transactions loan pools that were replete with loans that did not comply with the requisite underwriting guidelines and were made to borrowers who did not have the ability to repay their debts. As a result, Bear Stearns marketed and sold billions of dollars worth of securities backed by mortgage loans that did not conform with the disclosures, representations or warranties made as to the loans.

65. Bear Stearns' securitization machine was a successful and extraordinarily profitable enterprise for The Bear Stearns Companies, which further solidified and enhanced its sterling reputation and tremendous sway in all areas of mortgage finance. This success was short-lived. The recently uncovered truth is that Bear Stearns produced and disseminated toxic securities into the marketplace, backed by loans made to borrowers with no ability to pay the amounts as due over the life of the loans. As a result, while Bear Stearns executives reaped

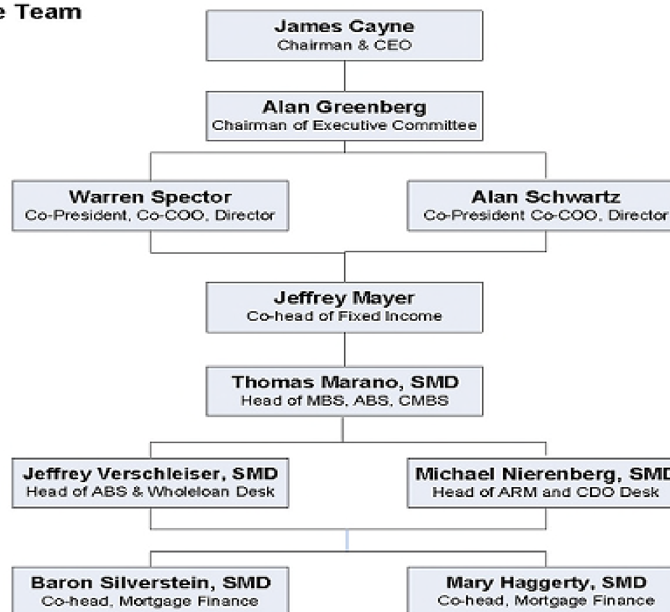
[71] *See Bear Naked Lenders*, Wall St. J., Mar. 18, 2008, at A22 ("Bear took particular pride in its risk management, but let its standards slide in the hunt for higher returns during the mortgage mania earlier this decade."); *see also* Michael Corkery, Fraud Seen as Driver in Wave of Foreclosures-Atlanta Ring Scams Bear Stearns, Getting $6.8 Million in Loans, Wall St. J., Dec. 21, 2007, at A1 ("During its first full year of business in 2006, Bear Stearns Residential Mortgage originated 19,715 mortgages for a combined $4.37 billion, according to data compiled by the Federal Reserve and analyzed by The Wall Street Journal. Bear Stearns Residential Mortgage rejected about 13% of applications, compared with an average denial rate of 29% nationally, according to the Fed data.")

enormous profits, their actions caused the company's sudden collapse in 2008, and destroyed the livelihood of millions of Americans (including those individuals that obtained loans that never should have been approved, or whose retirement plans invested in Bear Stearns' securitizations).

3. Bear Stearns Executives Drove Bear Stearns' Securitization Machine to Assume Inordinate Risk for Personal Gain

66. Bear Stearns' top executives were the key "decision-makers" who drove the Bear Stearns securitization machine and were responsible for Bear Stearns' fraudulent scheme and failure to implement the requisite controls relating to its securitizations. In the marketing materials disseminated to Ambac and investors to induce their participation in the Transactions, Bear Stearns identified, in their official capacities, the senior executives within Bear Stearns' Residential Mortgage Backed Securities Team as follows:[72]

Bear Stearns's Residential Mortgage Team



67. From their respective positions in the upper echelons of Bear, Stearns & Co.'s executive management, Cayne, Greenberg, Spector, and Schwartz directed or encouraged the

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[72] *See* June 2005 Bear Stearns RMBS Platform, www.emcmortgagecorp.com (ABK-EMC01515471-561 at p.5).

very policies and procedures undertaken to expand securitization volume for the sake of maximizing short-term profitability, with intentional or reckless disregard to the fraudulent disclosures used to market and sell the securities issued in connection with Bear Stearns' residential mortgage-backed securitization transactions. For example, Cayne, Marano, Mayer, Spector and Schwartz received internal audit reports specifying the need to establish and enhance controls relating Bear Stearns' quality control and claims operations, which resulted in the massive, undisclosed profits from the securitization of patently defective loans.[73] But those controls were not implemented, and specifically, the senior executives did not establish requisite protocols to ensure Bear Stearns was not securitizing pools replete with loans made to borrowers with no ability to repay. This upper management of Bear, Stearns & Co. thus enabled and encouraged all of its executives and managers to implement and perpetuate Bear Stearns' fraudulent scheme.

68. Co-Head of Fixed Income Jeffrey Mayer met with Ambac's then-CEO, and Managing Director of Consumer Asset-Backed Securities Department, in advance of the Transactions and represented Bear Stearns in soliciting Ambac's executives to induce Ambac's participation in Bear Stearns' securitizations.[74] Mayer also supervised various aspects of the

[73] Email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department) dated March 7, 2006, forwarding EMC Reps & Warrants Internal Audit Report dated Feb. 28, 2006, EMC-AMB 001496304-311.

[74] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to, among others, Nierenberg and Silverstein, dated August 29, 2005, EMC-AMB 003372069-070; Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to, among others, Nierenberg and Verschleiser, dated March 23, 2007, EMC-AMB 002290230.

mortgage-finance business, oversaw Bear Stearns' purported loan underwriting guidelines, and received, among other things, internal audit reports and memoranda regarding reserves.[75]

69. In the words of a former Bear Stearns executive, Senior Managing Directors Marano, Nierenberg and Verschleiser acted as the "decision-makers" during the relevant time frame who "were actively involved in running the mortgage business, which included servicing conduit, trading, etc."[76] Tom Marano was the Senior Managing Director and Global Head of Mortgage-Back Securities and Asset-Backed Securities "Decisions about how much risk to put on would have been made by the trading organization, which reported up to Tom Marano" and Marano "would have been well aware of the amount of risk that was being taken on in terms of acquiring assets and . . . the activities with respect to securitization[.]"[77] Marano reported directly to Co-Head of Fixed Income, Jeffrey Mayer.[78]

70. As the Co-Heads of Mortgage Trading, Senior Managing Directors Nierenberg and Verschleiser directly supervised the Co-Heads of Mortgage Finance, Mary Haggerty and Baron Silverstein, and had oversight in all aspects of Bear Stearns' mortgage-finance operations. For example, the traders responsible for determining which loans to package and securitize in the Transactions would report to Verschleiser.[79] In turn, Nierenberg and Verschleiser each reported to Marano.

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[75] *See, e.g.*, email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department), *supra* note 72; *see also* email from Marano to, among others, Mayer, dated January 25, 2008, EMC-AMB 005486312-327 (attaching MBS reserve memo).

[76] 4/26/2010 Golden Deposition Tr. at 252. *See also* Teri Buhl, *E-mails Show Bear Stearns Cheated Clients Out of Billions*, The Atlantic, Jan. 25, 2011 ("According to former Bear Stearns and EMC traders and analysts who spoke with *The Atlantic*, Nierenberg and Verschleiser were the decision-makers for the double dipping scheme . . . .").

[77] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 84-85, 91-92.

[78] 4/26/2010 Golden Deposition Tr. at 252.

[79] 6/2/2010 Smith Deposition Tr. at 122-23.

71. As the Co-Heads of Bear, Stearns & Co.'s Mortgage Finance Department, Haggerty and Silverstein each had oversight responsibilities that allowed for, and encouraged, the acquisition of defective mortgage loans to be pooled into the Transactions, and the management of the purported review of the loans before they were securitized. Starting in 2001, Haggerty's responsibilities were to "build," and then manage, "all aspects" of "creating a business where we could buy [loans] and securitize them."[80] She was also the signatory for Bear, Stearns & Co. in the Transaction documents, including the Underwriting Agreements for SACO 2006-2, SACO 2006-8 and BSSLT 2007-1. Between 2000 and 2007, Silverstein was also in charge of "taking a pool of mortgage loans and completing and executing the securitization process," including presentations to the rating agencies, coordinating with the trading desk for the securities to be issued, preparing the Registration Statements, Free Writing Prospectuses ("FWPs"), Prospectuses, and Prospectus Supplements ("ProSupps") (collectively, "Offering Documents") that were publicly filed with the U.S. Securities and Exchange Commission ("SEC") and used to market the securities, reviewing the due diligence performed for the securitized loan pool, and then coordinating the settlement and closing of the securitization transaction.[81] When asked what his specific role was in the process, Silverstein was resolute: "I would not manage – I would be responsible for each of these processes in relation to a securitization."[82]

72. After their securitization, Haggerty and Silverstein continued to oversee and manage the quality control process and, after Ambac submitted demands for repurchase of

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[80] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 35-36.

[81] 6/4/2010 Silverstein Deposition Tr. at 36-37; *see also* 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 37-38 (stating that Silverstein was responsible for "the process by which pools of mortgages are sent to a rating agency for analysis and the . . . preparation of the offering documents in connection with a securitization and then the closing and settlement of that securitization").

[82] 6/4/2010 Silverstein Deposition Tr. at 38 (emphasis added).

defective loans, participated in the decisions of whether to honor those demands. In connection with Bear Stearns' acquisition by JPMorgan Chase & Co., JP Morgan hired Haggerty and Silverstein to serve as two of the three Co-Heads of the transaction management group responsible for activities "in connection with sale, purchase, securitization, [and] servicing" of mortgage loans.[83] Haggerty currently works at JP Morgan as a Managing Director in the Securitized Products Group. Silverstein was a Managing Director in Mortgage Finance at JP Morgan until December 2008.

73. Bear Stearns' top executives adopted and succumbed to a compensation structure that created perverse incentives for Bear Stearns to purchase and securitize loans regardless of their quality in order to secure obscene payouts. Indeed, based on publicly available information, CEO James Cayne, Executive Committee Chairman Greenberg, Co-Presidents Alan Schwartz and Warren Spector earned an aggregate total of over ***$1 billion*** in total salary, bonus and stock benefits during the years preceding Bear Stearns' collapse in 2008. Even after accounting for the drop in stock value resulting from Bear Stearns' colossal failure, these individuals made an aggregate ***net payoff exceeding $650 million***. Meanwhile, the firm disintegrated, its shareholders' investments evaporated, and the loans it funded and securitized – and the mortgage-backed securities and other financial products linked to them – have wreaked unprecedented harm on borrowers, investors, and the economy as a whole.

74. These compensation packages for Bear Stearns' top executives are analyzed in a Yale Journal on Regulation article discussing the "moral hazard" risk resulting from the perverse incentives Bear Stearns' executives had to enhance their individual wealth by taking excessive risks with other peoples' money. The article concludes that paying out enormous performance-

[83] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 43. Haggerty admitted that she is also responsible for assisting Bear Stearns in defending litigations such as this one. *Id.* at 46.

based salaries and bonuses created incentives to seek short-term profits by taking excessive risks, including the decision to become heavily involved in the securitized asset markets, that ultimately led to Bear Stearns' failure in 2008:

> [T]he design provided executives with substantial opportunities (of which they made considerable use) to take large amounts of compensation based on short-term gains off the table and retain it even after the drastic reversal of [Bear Stearns'] fortune[]. ***Such a design provides executives with incentives to seek improvements in short-term results even at the cost of maintaining an excessively elevated risk of an implosion at some point down the road***.[84]

75. Similarly, Bear Stearns awarded the lower tiers of executives within Bear Stearns' "Residential Mortgage Team" with extraordinarily high compensation that was ***directly correlated*** to the performance and expansion of Bear Stearns' securitization machine. Consequently, during the height of Bear Stearns' securitization machine, Marano, Nierenberg, and Verschleiser received stratospheric compensation,[85] with the majority paid out as cash bonuses. Others on Bear Stearns' trading desks also were handsomely compensated for increasing the volume and pace at which loans were fed into the securitization pipeline. Between 2005 and 2007, remarkable bonuses were awarded to the trading desk executives that Bear Stearns identified as directly responsible for effectuating each of the Transactions at issue.

76. The means and the motivation were the same – money, and lots of it – to churn out securitizations from the Bear Stearns machine regardless of the consequences.[86]

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[84] *See* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008* (2010), 27 YALE J. ON REG. 257, 274 (2010)(emphasis added).

[85] The actual dollar amounts of the compensation over time, and correlation to the volume of securitizations, has been deemed "attorneys-eyes only" by Bear Stearns and, therefore, has not been recited herein.

[86] The moral hazard is evidenced by the Bear Stearns senior executives' conduct that was inconsistent with the interests of the shareholders of The Bear Stearns Companies. For instance, Bear Stearns

77. The complete apathy and callous disregard that the architects of these securitizations had for those they were defrauding and harming is illustrated in correspondence involving Jeff Wise, EMC's former senior vice president responsible for seller approval and current Senior Vice President of Seller Approval at JP Morgan. An August 2008 email sent to Wise by a Countrywide executive mockingly revised a New York Times article by journalist Louise Story, which had addressed the alarming market meltdown from the RMBS crisis, to state:

> "Virtually everybody was frankly slow in recognizing that we were on the cusp of a really draconian crisis because ***we were having too much fun waiving shit in and getting loaded on Miller Lite***. Hell! I had a guy that rolled in [sic] Corvette for chrissakes! said Jeff Wise, a former EVP of Credit Risk at Countrywide Securities Corp".[87]

The email contains additional lewd and disdainful comments that will not be recited herein.

4. JPMorgan Chase & Co. Acquired Bear Stearns' Securitization Machine at a Fire Sale in 2008

78. Bear Stearns' house of cards collapsed in the spring of 2008. Following its unprecedented collapse, The Bear Stearns Companies and its affiliates – including EMC and Bear, Stearns & Co. – were acquired by JPMorgan Chase & Co. in a fire sale for only $10 a

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represented to the SEC and the shareholders that it would sell its positions in the Transactions. *See, e.g.*, Email from Michael Sinapi (Bear Stearns & Co.) to Nierenberg and Verschleiser, among others, dated October 5, 2006, EMC-AMB 001496565-567 ("Bear told the SEC that our intent is to sell, not hold, our securities after securitization."). Bear Stearns failed to do so through 2006, and in 2007, shortly after the last Transaction, it rushed to do so, knowing but failing to disclose that its securitizations were doomed to fail. *See, e.g.*, Email from Marano to Nierenberg and Verschleiser, among others, dated May 11, 2007, EMC-AMB 003501771-772 ("You guys need to get a hit team on blowing the retained interest bonds out asap. This is the biggest source of balance sheet problems."). It was too late.

[87] Email from James Baker (and John Relihan) at Countrywide to Jeffrey Wise (EMC Mortgage Corp. Senior Vice President, Seller Approval), and associates at Countrywide, including Adam Gadsby, Adam Robitshek, David Kister, Jeremy Meacham, Jordan Cohen , Peter Van Gelderen and Xerxes Sarkary, dated August 6, 2008, EMC-AMB 010730188 – 91 (emphasis added).

share, which was funded, in part, through a $29 billion non-recourse loan from the American taxpayers.

79. Immediately upon assuming control over of what was left of Bear Stearns, JP Morgan deliberately frustrated investors' and insurers' rights in the Bear Stearns securitizations to avoid JPMorgan Chase & Co. from having to account for Bear Stearns' massive exposure related to its securitizations on its consolidated financial statements. As discussed below, JP Morgan interfered with EMC's contractual obligations including Ambac's and other insurers' and investors' legal remedies relating to the toxic loans backing Bear Stearns securitizations by asserting deceptive and contradicting positions regarding those loans so as to manipulate accounting reserves and block the repurchase of breaching loans in the Transactions.

B. BEAR STEARNS MADE MATERIALLY FALSE AND MISLEADING DISCLOSURES TO INDUCE PARTICIPATION IN ITS SECURITIZATIONS

80. In advance of closing a contemplated securitization deal, Bear Stearns made myriad false and misleading representations directly to investors, insurers, and rating agencies to induce their participation and complete the intended transaction.

81. Bear Stearns followed virtually the same routine in communicating its false and misleading representations to effectuate its securitizations, including the Transactions at issue here. First, Bear Stearns made presentations and disclosures to investors and financial guarantors concerning its securitization operations and the particular transaction contemplated. Second, Bear Stearns provided to the financial guarantors and rating agencies mortgage loan "tapes" (data files with key information for each loan proposed for securitization) that were supposed to contain the true and accurate loan attributes critical to assess the risks associated with the loans to be securitized. Third, Bear Stearns sent financial guarantors information pertaining to the historical performance of loans that Bear Stearns had previously securitized.

Fourth, Bear Stearns secured ratings on various classes of securities to be issued in the contemplated transaction from the rating agencies. Fifth, Bear Stearns disseminated draft and final Offering Documents to financial guarantors and investors purporting to describe the transaction and its associated risks.

1. Bear Stearns Knowingly Made Materially False and Misleading Statements in Its Marketing Presentations and Deal Correspondence

82. Throughout the relevant period, from 2005 to April 2007, Bear Stearns routinely made presentations to investors and financial guarantors to induce their participation in Bear Stearns' securitizations.[88] The presentations were made at Bear Stearns' "Investor Days" by, among others, Bear, Stearns & Co. directors Thomas Marano, Michael Nierenberg, Jeffrey Verschleiser and Ralph Cioffi. The Investor Day presentations were supplemented by direct communications with securitization participants in advance of particular transactions. Bear Stearns' investor relations department and the deal managers responsible for particular transactions disseminated these presentations, which were based on information assembled by, and in conjunction with, employees from its mortgage-loan conduit.[89] As part of the presentations, Bear Stearns provided investors and financial guarantors with information (*e.g.*, PowerPoint presentations known as "marketing decks") concerning the Bear Stearns mortgage-loan conduit and its purported securitization practices.[90]

83. At Bear Stearns' invitation, Ambac attended a number of Investor Day presentations. Bear Stearns provided Ambac with the marketing decks and other documentation

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[88] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 121.

[89] 4/19/2010 Glory Deposition Tr. at 69-71.

[90] 4/19/2010 Glory Deposition Tr. at 166-67 (testifying that it was Bear Stearns' practice to provide marketing packages in advance of securitizations).

regarding the Bear Stearns mortgage-loan conduit. And, in advance of the Transactions, Bear Stearns reinforced the disclosures made at the Investor Day and in the marketing decks.

84. By way of example, Bear Stearns gave Ambac a marketing deck in advance of and to induce Ambac's participation in the SACO 2005-10 and 2006-2 Transactions, dated as of June 2005;[91] in advance of and to induce Ambac's participation in the SACO 2006-8 Transaction, dated as of May 11, 2006;[92] and in advance of and to induce Ambac's participation in the BSSLT 2007-1 Transaction, dated as of March 13, 2007.[93] The presentations followed a standardized format, and the 2005 deck is illustrative as to the representations made:

- Integrated Entities: Bear Stearns first emphasized the integrated nature of its securitizations operations. Indeed, the front cover of the presentation is titled "Bear Stearns RMBS Platform," lists an EMC website, and includes Bear, Stearns & Co. Inc.'s name and address. The presentation then provides an organization chart of the "Bear Stearns' Residential Mortgage Team" that shows a seamless reporting line from EMC up to Bear Stearns' Chairman and CEO. Then, to make explicit the interrelation of the affiliates in the mortgage loan conduit, the next slide asks "Why purchase RMBS from Bear Stearns?" and answers by referencing the "Integral role played by Bears affiliate, EMC Mortgage Corporation (EMC)."

- Seller Approval and Monitoring: Bear Stearns next lauded its purported processes for screening and monitoring the originators from which it purchased loans for its securitizations. Among other things, Bear Stearns contended that it tracked metrics regarding the sellers' loans that were predictors of loan quality, including the level of loan EPDs, delinquencies, quality control findings, and repurchases.

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[91] Investor Presentation, dated June 2005, ABK-EMC01515471-561.

[92] Investor Presentation, dated May 11, 2006, ABK-EMC01519818-949; *see also* Investor Presentation, undated, attached to the email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance), dated September 13, 2006, ABK-EMC01533424 - 446

[93] Investor Presentation, dated March 13, 2007, attached to the email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 22, 2007, ABK-EMC01555076-269 ("I have attached the Investor Day Presentation that will give you a better idea of who EMC is and our processes.").

- Due Diligence: Bear Stearns then described the "due diligence" protocols it purported to have implemented to prevent defective mortgage loans from entering the securitizations. For instance, the deck asserted that Bear Stearns conducted due diligence for "100%" of the subprime loans it securitized from its two primary means of acquiring loans, the so-called "flow" and "bulk" channels. To add a false veneer of integrity to the process, Bear Stearns emphasized that it retained the third party due diligence firms Clayton Holdings, LLC. ("Clayton") and Watterson-Prime Consulting LLC ("Watterson Prime") to conduct its pre-acquisition review of the loans.

- Quality Control: Bear Stearns next touted the quality control processes that it purportedly conducted after the securitizations closed to identify any defective loans that may have circumvented its due diligence protocols. As with the due diligence representations, Bear Stearns emphasized the broad scope of its quality control (including random and targeted sampling, referrals from the servicing department and other departments of EMC, and "100%" review of new sellers' loans), the extensive re-verification of loan information purportedly undertaken, and the third party consultants it retained to conduct the analysis.

- Repurchase Processes: Bear Stearns then conveyed that it had an entire "conduit team" devoted to asserting breach-of-representation-and-warranty claims, on behalf of the securitization participants, for the repurchase of loans identified as defective by the quality control process.

- Historical Performance: Finally, Bear Stearns provided appendices with extensive data purporting to reflect the performance of its prior securitizations and the loans therein.

85. Cheryl Glory – the Bear, Stearns & Co. Managing Director for United States Residential Mortgage Backed Securities ("RMBS") Investor Relations – acknowledged that the representations were intended to convey to investors and financial guarantors that (i) Bear Stearns implemented stringent protocols, (ii) to ensure the securitizations contained quality loans, and (iii) for the benefit of the investors and financial guarantors.[94] Haggerty also confirmed that Bear Stearns made these presentations understanding that the information "would

[94] 4/19/2010 Glory Deposition Tr. at 109-10 (Bear Stearns intended investors and financial guarantors to believe they benefited from the quality control processes), 110-119 (Bear Stearns intended investors and financial guarantors to rely on the benefits from the seller approval and monitoring processes).

contribute to the investor's decision to invest in the securitizations," and in order to "solicit their participation in transactions."[95]

86. In advance of each deal, Bear Stearns reinforced the disclosures made at the Investor Days and in the marketing decks through email and oral communications. For example, to underscore the information that Bear Stearns conveyed before the SACO 2005-10 Transaction regarding the purported due diligence conducted on loans, Cheryl Glory sent an email to Ambac titled "Follow-up questions on SACO 2005-10," stating:

> For the SACO 2005-10 deal, Group I is our bulk purchases and Group II is the flow. Our diligence for flow is generally 100%, with a minimum of 20% for a repeat well known seller such as SunTrust. As provided in the presentation materials for Investor Day, flow diligence includes credit, appraisal and compliance for the sample size. Bulk diligence is 100% for subprime and Alt B with a minimum 20% for prime Alt A. Bulk diligence would also include credit, appraisal and compliance for the sample.[96]

87. Similarly, in advance of and to induce Ambac to participate in the BSSLT 2007-1 Transaction, on March 22, 2007, Bear, Stearns & Co. analyst Soung Ho Park provided Ambac with (i) EMC's most recent investor presentation designed to offer a "better idea of who EMC is and our processes," and (ii) newly-implemented underwriting guidelines and matrices, purportedly put in place to originate a large portion of the loans in the BSSLT 2007-1 Transaction.[97] Four days later, Cheryl Glory sent Ambac an email dated March 26, 2007 to (i) lock in a date for a visit by Ambac to EMC's headquarters in Texas, (ii) confirm that Bear

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[95] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 113, 121.

[96] Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Ervin Pilku (Ambac Associate, MBS Department of Structured Finance), dated December 13, 2005, ABK-EMC01534777. The SACO 2005-10 ProSupp stated that the loans were subprime, and thus purportedly subjected to 100% due diligence review. *See* SACO 2005-10 ProSupp, at S-4.

[97] Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 22, 2007, ABK-EMC01555076-077 ("I have attached the Investor Day Presentation that will give you a better idea of who EMC is and our processes. In addition, I have also attached the guideline updates that were effective as of 1/12/07.").

Stearns would provide a representation and warranty concerning the truth of the mortgage-loan data it provided, and (iii) confirm that Bear Stearns would provide to Ambac results of due diligence purportedly conducted on the securitized loan pools:

> I have attached the "Save the Date" for a visit to EMC in April or May. In addition some clarification on the earlier email from Soung: . . . [W]e do provide a rep and warranty that "the information set forth in the Mortgage Loan Schedule hereto is true and correct in all material respects[.]" Jeff will . . . provide you with the due diligence results for all three deals once complete.[98]

88. These communications, which Bear Stearns intended to provide additional assurances to investors and Ambac regarding the quality of the loans and the integrity of Bear Stearns' protocols, were materially false and misleading in several ways. Contrary to its affirmative representations, Bear Stearns knew full well that (i) its due diligence protocols were inadequate to screen out defective loans or deliberately abandoned through overrides,[99] (ii) its seller monitoring controls were a farce,[100] (iii) its quality control and repurchase processes were designed to secure recoveries for Bear Stearns to the exclusion of, and without notice to, the securitizations,[101] and, as a result, (iv) the historical performance data did not reflect the true level of defective loans in the securitized pools. Ambac would not have entered into the Transactions had it known Bear Stearns' disclosures were false and misleading.

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[98] Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Gary Gal (Ambac Vice President, MBS Department of Structured Finance), Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance) and Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 26, 2007, ABK-EMC03206645.

[99] *See* Section III.C.1, below.

[100] As early as October 2005, Bear Stearns eliminated its reports that tracked defective loans, and when it downgraded a seller to terminated or suspended status, Bear Stearns stopped conducting quality control of the sellers so it could move the loans into securitizations. *See* Sections III.C.3 and III.C.7, below.

[101] *See* Section III.C.3, below.

2. Bear Stearns Knowingly Disseminated Materially False and Misleading Mortgage-Loan Tapes

89. As part of its initial solicitation to participants in a contemplated securitization, Bear Stearns sent by email certain information concerning the contemplated transaction structure and the loans proposed for securitization. Bear Stearns included in *all* these initial distributions to the financial guarantors and rating agencies the mortgage-loan tape that it asserted contained true, accurate, and complete information pertaining to critical attributes of the loans to be securitized. More specifically, the tapes listed for each loan the data metrics that insurers and rating agencies used as fixed inputs for their cash flow and risk modeling.

90. Consistent with this general practice, Bear Stearns sent loan tapes directly to Ambac in the days leading up to the closing date of each Transaction – on December 28, 2005,[102] January 3, 2006,[103] September 13, 2006,[104] and April 10, 2007.[105]

91. Ambac required and relied on these tapes as a critical component in its decision of whether to provide insurance for the deal, and rating agencies relied on the tapes as a critical component in determining the ratings to be assigned to each class of securities being issued.

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[102] Email from Audrey Kingsley (Bear, Stearns & Co. Inc, Vice President) to, among others, Ervin Pilku (Ambac Associate, MBS Department of Structured Finance) and Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated December 28, 2005, ABK-EMC01525295-296 (SACO 2005-10).

[103] Email from Audrey Kingsley (Bear, Stearns & Co. Inc, Vice President) to, among others, Ervin Pilku (Ambac Associate, MBS Department of Structured Finance) and Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated January 3, 2006, ABK-EMC03004619-620 (SACO 2006-2).

[104] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager on SACO 2006-8) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated September 13, 2006, ABK-EMC01536245 (SACO 2006-8); *see also* email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8) to Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance), dated June 18, 2006, ABK-EMC01532035 (sending prior version of SACO 2006-8 tape).

[105] Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated April 10, 2007, ABK-EMC01555428 (BSSLT 2007-1).

Ambac used the data on the tapes as fixed inputs to its models, and analyzed the loan metrics, which were central to assessing the risk associated with the loan pool and predicting the expected rates and severity of defaults by the borrowers. The following were some of the key metrics included on the tapes:

- the combined loan-to-value ratio ("CLTV") for each loan, which measures the total amount of mortgage debt that encumbers a property against the value of the property;
- the FICO (or credit) score for each borrower;
- the debt-to-income ratio ("DTI") for each borrower, which compared payments due on a borrower's monthly debts to a borrower's income;
- the occupancy status of the property, which listed whether the property was the borrower's primary or secondary residence, or an investment property; and
- the "doc-type" of each loan, which described the program pursuant to which the loan was originated, and which specified the information borrowers were required to disclose concerning their income, employment, and assets, and how such information would be verified.

92. Bear Stearns knew that Ambac and the rating agencies would rely, and intended that they rely, on the veracity of the tape data to evaluate the Transactions and assess the "market risks" pertaining to the loans.[106] In light of the recent revelations about Bear Stearns' due diligence and quality control practices, it is clear that it fully understood the inadequacy of those controls, and, therefore, knew the tapes contained false and misleading data – or recklessly disregarded the veracity of the disclosures. Indeed, Ambac's loan-level review (conducted at enormous effort and expense after the losses in the Transactions began to mount) has confirmed that those loan tapes contain materially false and misleading data.

[106] 6/2/2010 Smith Deposition Tr. at 67-72, 83; 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 213-15; 4/19/2010 Glory Deposition Tr. at 65.

3. Bear Stearns Knowingly Disseminated Materially False and Misleading Data Concerning the Historical Performance of Its Earlier Securitizations

93. As part of its representations to induce participation in a contemplated securitization, Bear Stearns disseminated historical data showing the performance of previously securitized loans bearing similar attributes to the loans proposed for securitization.

94. Consistent with its general practices, in advance of the Transactions, Bear Stearns included historical performance data in its investor presentations and marketing decks disseminated to Ambac to induce its participation. Bear Stearns also disclosed more detailed historical data in its solicitations leading up to two of the Transactions –SACO 2006-8 and BSSLT 2007-1.[107]

95. Bear Stearns knew that these disclosures were critical to Ambac's assessments of the risks and, ultimately, Ambac's decision to issue its insurance policies in each of the Transactions. Specifically, it knew that Ambac considered and evaluated Bear Stearns' disclosures in advance of the Transactions concerning the performance of comparable loans in previous Bear Stearns securitizations to assess the risks and expected future performance (and, thus, structural protections needed for its financial guaranty insurance) of the loans intended for the contemplated transaction.[108]

96. The historical performance data was materially misleading in that Bear Stearns failed to disclose that it intentionally adopted practices and policies (*e.g.*, its due diligence,

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[107] 6/2/2010 Smith Deposition Tr. 158; Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 19, 2007, ABK-EMC01554766-768. *See also* E-mail from Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance) to Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager on SACO 2006-8), dated August 8, 2006, EMC-AMB 004311998-999.

[108] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 30, 2007, ABK-EMC01536369-370.

quality control, and EPD policies) that it knew had resulted in the securitization of defective loans in those earlier transactions – loans that were prevented from defaulting solely by virtue of the ability of the borrowers to refinance or sell their homes due to easy credit fueled by an artificially inflated real estate market. Bear Stearns thus knew that prior performance of the loans, including those in earlier Transactions, was not in any way indicative of their quality or the likely performance of the similarly defective loans in the Transactions. Rather, Bear Stearns knew and actively concealed that it was building a house of cards, waiting to collapse as soon as borrowers lost the ability to refinance or "flip" their way out of loans they could not afford to pay. By concealing the true quality of its collateral, Bear Stearns deliberately misled Ambac and other investors into participating in Bear Stearns' securitizations.

4. Bear Stearns Knowingly Supplied Materially False and Misleading Information to Secure Rating Agency Ratings

97. Bear Stearns provided false and misleading information to rating agencies Standard & Poor's, Moody's, and Fitch to secure "shadow ratings" and "final ratings" required to induce financial guarantors to insure and investors to purchase the securities issued in connection with its securitizations, including the Transactions at issue. A shadow rating is an assessment of the value or risk of a mortgage-backed security without consideration of the protection afforded by a financial guaranty insurance policy.[109] A final rating is an assessment of the value or risk of the security taking into consideration the financial guaranty policy.

98. Bear Stearns knew full well that Ambac used the shadow ratings in deciding whether to participate in the Transactions. In fact, Ambac expressly conditioned the issuance of

[109] 4/19/2010 Glory Deposition Tr. at 55-56 ("It's only upon wrapped transactions where the wrapper does not necessarily need to have a rating issued for it to be sold because you're relying on the wrapper's rating."); 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 204. ("A shadow rating is a rating which is not necessarily published . . . it is an expected rating given that certain set of criteria or circumstances are met.").

its financial guaranty insurance policies on the ability to secure a specified shadow rating and a final rating for each Transaction. For example, in connection with the SACO 2005-10 Transaction, Ambac "agreed to issue the Policy . . . subject to satisfaction of the conditions precedent," including that Ambac "shall have received confirmation that the risk insured by the Policy constitutes at least a 'A' risk by S&P, a 'A' risk by Fitch, and a 'A2' risk by Moody's, and that the [insured] certificates when issued, will be rated 'AAA' by S&P, 'AAA' by Fitch and 'Aaa' by Moody's."[110] Likewise, in advance of the BSSLT 2007-1 Transaction, Ambac expressly informed Bear Stearns' representative negotiating the Transaction that its bid "should map to S&P AA rating loss coverage levels, which was a **requirement** when we presented the deal internally."[111]

99. Bear Stearns similarly knew that investors relied, and intended that they rely, on the rating agency ratings in deciding whether to purchase the securities issued in the Transactions. It was for that reason that the Offering Documents used to market the Notes expressly stated that a final rating was a condition precedent to Bear Stearns' offering of the securities.[112]

100. For each of the Transactions, Ambac received shadow ratings that were derived from information supplied to the rating agencies by Bear Stearns. For example, in connection with Ambac's participation in the SACO 2006-2 Transaction, Standard & Poor's issued a "private credit assessment" (*i.e.*, shadow rating) to Ambac stating:

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[110] SACO 2005-10 I&I Agreement § 3.01(x). The I&I for the SACO 2006-2, 2006-8 and BSSLT transactions contain virtually identical language, and differ only in the specific ratings assigned by each agency for the particular Transaction.

[111] E-mail from Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance) to Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side), dated March 21, 2007, ABK-EMC01551116 (emphasis in original).

[112] *See* Section III.B.5, below.

> Pursuant to your request we have reviewed the information presented to us and . . . have assigned a private credit assessment of "A" to these obligations without the benefit of the surety bond. . . . Standard & Poor's relies on the issuer and its counsel, accountants, and other experts for the accuracy and completeness of the information submitted in connection with the private credit assessment.[113]

101. Bear Stearns also solicited and obtained from the rating agencies *final* ratings of the certificates issued in the Transactions, which took into account Ambac's financial guaranty insurance policies.[114] For example, in connection with the SACO 2005-10 Transaction, Standard & Poor's issued a rating letter to Bear, Stearns & Co. stating:

> Pursuant to your request for a Standard and Poor's rating on the above-referenced obligations, we have reviewed the information submitted to us and, subject to the enclosed *Terms and Conditions*, have assigned a rating of 'AAA.' . . . The rating is based on information supplied to us by you or by your agents . . . . Standard and Poor's relies on the issuer and its counsel, accountants, and other experts for the accuracy and completeness of the information submitted in connection with rating.[115]

102. To secure the shadow ratings and, thus the final ratings, Bear Stearns disseminated the same false and misleading data to the rating agencies that it provided to insurers like Ambac, including marketing presentations, loan tapes, and Offering Documents. As a Bear Stearns Managing Director characterized the process:

> So there is a process when you request a rating agency to look at or engage in a specific transaction. You provide them a pool of collateral and you provide them structure. As a result of them providing you [get] back ratings and a rating agency gets picked for a transaction, you will then go down the path of providing to

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[113] Letter from Standard & Poor's Ratings Services to Ervin Pilku (Ambac Associate, MBS Department of Structured Finance) regarding SACO I Trust 2006-2, dated January 30, 2006, ABK-EMC01620782-785 at 782 (emphasis added).

[114] 4/19/2010 Glory Deposition Tr. at 55.

[115] Letter from Standard & Poor's to Bear, Stearns & Co. and Ambac, dated December 30, 2005, EMC-AMB 000008015-023 at 8015 (emphasis added). For each of the Transactions, one or more of the rating agencies issued rating letters.

> them marketing materials, such as the term sheet and a pro supp, for them to sign off and understand and then there is a PSA that they will review and provide comments on.[116]

103. The "pool of collateral" that Bear Stearns disclosed to the rating agencies was the same mortgage-loan data provided to Ambac.[117] According to Bear Stearns, the rating agencies used the loan data to model the risk and generate the ratings for the securitizations. The rating agencies would develop models to evaluate "the expected loss or expected probabilities of default for various rating standards," which "took as a given the veracity of the attributes and metrics on the mortgage loan file provided to them."[118] Bear Stearns also gave the rating agencies marketing presentations that included the same false and misleading disclosures made in the marketing decks provided to Ambac and investors.[119] Thus, just as Ambac, in assessing the risk of the Transactions, relied on the truth and accuracy of the loan data Bear Stearns supplied and the representations Bear Stearns made, so too did the rating agencies.[120]

104. EMC generally gathered this requisite information and Bear, Stearns & Co. in turn conveyed it to the ratings agencies.[121] Cheryl Glory, a Bear, Stearns & Co. Managing Director, who was lured away from her position at the Fitch rating agency in 2005 to join Bear

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[116] 4/19/2010 Glory Deposition Tr. at 61-62; *see also id.* at 40-55; *see also* 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 195-97 (same).

[117] Email from Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance) to Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8), dated September 13, 2006, ABK-EMC01524131-132 (in connection with the SACO 2006-8 transaction, "Nick- please let me know if the rating agencies looked at the refreshed tape and the outcome.").

[118] 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 196, 200. Haggerty also confirmed that the "[r]ating agencies typically received collateral information on the individual pools that they were being asked to rate in connection with a transaction and there would be discussion with the rating agencies about the overall platform in general." 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 117-18.

[119] 4/19/2010 Glory Deposition Tr. at 63-64

[120] *See* Section III.B.2, above.

[121] 4/19/2010 Glory Deposition Tr. at 69-70; *see also* 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 200-201 (loan level characteristics and data would be provided to the rating agencies by "an employee of Bear Stearns as the underwriter").

Stearns & Co., was responsible for preparing and disseminating the information to the rating agencies.[122] Bear, Stearns & Co. deal managers also provided information to rating agencies for the transactions they worked on.[123] This included Nick Smith, Bear, Stearns & Co.'s deal manager for the SACO 2006-8 Transaction and wordsmith of the Transaction's "SACK OF SHIT" appellation.[124]

105. Because they were based on the same false and misleading information provided to Ambac and investors, the shadow ratings were false and misleading. The final ratings, in turn, were false and misleading because they were given in reliance on Ambac's insurance policies, which were obtained by virtue of the fraudulently obtained shadow ratings. These ratings therefore added another critical layer of false assurances to investors as to the quality of the securitized loan pools.

5. Bear Stearns Knowingly Made Materially False and Misleading Representations and Disclosures in the Offering Documents to Market and Sell the Notes

106. Bear Stearns marketed the securities issued in its securitizations, including the Transactions, pursuant to Offering Documents[125] that were publicly filed with the SEC pursuant to the Securities Act of 1933. As a matter of law, the Offering Documents were required to disclose all material facts concerning the securities offered; not contain any untrue statement of

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[122] 4/19/2006 Glory Deposition Tr. at 15-16, 20 (Bear, Stearns & Co. Managing Director, Cheryl Glory, had worked at Fitch for 8 years prior to her retention), 50 ("I provided the information that I felt would be appropriate to provide to the rating agencies.").

[123] 4/19/2010 Glory Deposition Tr. at 63-64 ("Pitches . . . [c]ould have been provided by the deal management team. So the deal manager responsible for a given transaction.").

[124] Email from Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance) to Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8), dated September 13, 2006, ABK-EMC01524131-132 ("Nick, please let me know if the rating agencies looked at the refreshed tape and the outcome.").

[125] The Offering Documents are defined above to include the Registration Statements, Free Writing Prospectuses, Prospectuses, and Prospectus Supplements.

material fact concerning the securities; not omit to disclose any material fact concerning the securities; and not omit to state a material fact necessary to make the statements made therein, in light of the circumstances in which they were made, not misleading.

107. The Registration Statements and Free Writing Prospectus ("FWPs") were filed with the SEC several days in advance of the contemplated closing date for a securitization; the ProSupps were then filed with the SEC at or around the closing date. The ProSupps filed in connection with the Transactions each state that "Bear, Stearns & Co. Inc., as the underwriter, will offer the certificates listed above at varying prices to be determined at the time of sale."[126]

108. In advance of the closing date for each Transaction, Bear Stearns also prepared and sent to Ambac drafts of the FWPs and the ProSupps to induce its participation in the Transactions. For instance, fifteen days before the December 30, 2005 closing of the SACO 2005-10 Transaction, Bear Stearns' counsel sent Ambac a draft of the FWP.[127] A "preview" of the ProSupp followed eight days later.[128] Indeed, Bear Stearns disseminated updated drafts of the Offering Documents on at least twenty separate occasions prior to closing that Transaction. Similarly, Bear Stearns sent Ambac draft FWPs and ProSupps before the closing date for each of the other three Transactions.[129] The draft FWPs and ProSupps contained false and misleading

[126] SACO 2005-10 ProSupp at S-1; SACO 2006-2 ProSupp at S-1; SACO 2006-8 ProSupp at S-1; BSSLT 2007-1 ProSupp (Group I) at S-1; BSSLT 2007-1 ProSupp (Group II & III) at S-1.

[127] Email from Musa Abdul-Basser (Thacher Profitt & Wood, counsel for Bear Stearns) to Ambac, among others, dated December 15, 2005, ABK-EMC02729306-309.

[128] Email from Musa Abdul-Basser (Thacher Profitt & Wood, counsel for Bear Stearns) to Ambac, among others, dated December 23, 2005, ABK-EMC01528037-8038.

[129] Bear Stearns sent Ambac an initial draft of the FWP fifteen days prior to the January 30, 2006 closing date of the SACO 2006-2 transaction, EMC-AMB 006607559-560; sixteen days prior to the September 15, 2006 closing date of the SACO 2006-8, ABK-EMC03077662-663; and nineteen days prior to the April 30, 2007 closing date of the BSSLT transaction, ABK-EMC02865923-924.

statements and omissions similar to those made in the Offering Documents eventually filed with the SEC.

109. Bear Stearns knew and intended that Ambac and investors would rely on these draft and final Offering Documents in assessing whether to participate in the Transactions. That was the very purpose for which the documents were created and disseminated. Through those disclosures, Bear Stearns deliberately misled investors and induced Ambac to provide financial guaranty insurance for securitizations plagued by defective loans that did not comport with the characteristics represented in the Offering Documents.

110. The disclosures in the Offering Documents of the risks associated with the securitization were false and misleading in that they (i) mischaracterized the origination and underwriting practices, (ii) presented false data metrics pertaining to the securitized loan pools, (iii) provided false and misleading ratings, and (iv) failed to disclose Bear Stearns' complete abdication of its due diligence and quality control processes, which it knew resulted in the securitization of pools replete with defective loans.

111. ***Origination and underwriting practices:*** The Offering Documents sent by Bear Stearns to Ambac and filed with the SEC in connection with each Transaction contained numerous statements purporting to describe the underwriting standards that were applied to assess borrowers' creditworthiness and ensure the quality of the loans in the Transactions. For example, the ProSupp in the BSSLT 2007-1 Transaction (Group I) disclosed that the loans (which consisted of HELOCs) were originated pursuant to underwriting standards designed to "evaluate the borrower's credit standing and repayment ability, and the value and adequacy of

the mortgaged property as collateral," which it also represented were "consistent with those utilized by mortgage lenders generally" at the time.[130]

112. The ProSupps for the Transactions also specifically describe the underwriting guidelines purportedly used by the largest originators of the loans in the Transactions. The ProSupp for the SACO 2006-2 Transaction disclosed that American Home Mortgage Investment Corp., which originated the greatest number of loans for that Transaction and the second-greatest number of loans across all four Transactions, "underwrites a borrower's creditworthiness base[d] solely on information that the Originator believes is indicative of the applicant's ***willingness and ability to pay the debt they would be incurring***."[131] This originator's "underwriting philosophy" is described as "weigh[ing] all risk factors inherent in the loan file, giving consideration of the individual transaction, borrower profile, the level of documentation provided and the property used to collateralize the debit."[132] The ProSupps for the BSSLT 2007-1 (Groups I, II, and III) Transaction similarly discuss the underwriting guidelines employed by GreenPoint[133] and Bear

[130] BSSLT 2007-1 (Group I) ProSupp, at S-28 – S-29; *see also* BSSLT 2007-1 (Groups II & III) ProSupp, at S-41-S-44. *See also* SACO 2006-2 ProSupp at S-34 ("The Originator underwrites a borrower's creditworthiness based solely on information that the Originator believes is indicative of the applicant's willingness and ability to pay the debt they would be incurring."); SACO 2006-8 ProSupp at S-26 (noting that the originator "underwrites a borrower's creditworthiness based solely on information that [it] believes is indicative of the applicant's willingness and ability to pay the debt they would be incurring.").

[131] SACO 2006-2 ProSupp, at S-34 (emphasis added). *See also* SACO 2006-8 Transaction ProSupp at S-25 – S-26 (describing in similar fashion American Home Mortgage Corp.'s underwriting guidelines with respect to HELOCs).

[132] SACO 2006-2 ProSupp, at S-34.

[133] GreenPoint has been faced with a wave of litigation arising from its origination of defective mortgage loans. *See U.S. Bank Nat'l Ass'n v. GreenPoint Mortgage Funding, Inc.*, No. 600352-2009 (N.Y. Sup. Ct. April 14, 2010); *Steinmetz v. GreenPoint Mortgage Funding, Inc.*, No. 08-CV-5367 (S.D.N.Y. June 11, 2008); *Ferguson v. GreenPoint Mortgage Funding, Inc.*, No. 08-CV-60854 (S.D. Fla. June 5, 2008); *Lewis v. GreenPoint Mortgage Funding, Inc.*, No. 1:08-CV-567 (E.D. Va. June 3, 2008); *Ouziz v. GreenPoint Mortgage Funding, Inc..*, No. 3:08-CV-2201 (N.D. Cal. Apr. 29, 2008); *Perez v. GreenPoint Mortgage Funding, Inc..*, No. 5:08-CV-1972 (N.D. Cal. Apr. 15, 2008); *Ramirez v. GreenPoint Mortgage Funding, Inc.*, No. 3:08-CV-369 (N.D. Cal. Jan. 18, 2008); *Knapp v. GreenPoint Mortgage Funding, Inc.*, No. CIV 466080 (Cal. Super. Ct. Sept. 14, 2007); *Feinstein v. GreenPoint Mortgage Funding, Inc.*, No. 07-CV-1851 (E.D. Pa. May 7, 2007).

Stearns Residential Mortgage Corporation (a Bear Stearns affiliate), which originated a significant number of loans in that Transaction.[134]

113. The Offering Documents also explain that the underwriting guidelines allow for ***exceptions*** to be made on a case-by-case basis for borrowers that meet specific criteria described as "compensating factors." For example, the ProSupp for the SACO 2006-2 Transaction notes that "there may be some acceptable quality loans that fall outside published guidelines."[135] The ProSupp asserted that, for these loans, "***common sense***" factors were used to weigh each case individually on its own merits and "exceptions to . . . underwriting guidelines are allowed ***if sufficient compensating factors exist to offset any additional risk due to the exception***."[136]

114. The Offering Documents also disclosed that reduced-documentation loan programs, which accounted for a significant number of the loans in the Transactions, were used for those borrowers that demonstrated their creditworthiness through other compensating factors. For instance, the BSSLT 2007-1 (Group 1) ProSupp states that "[e]xceptions to documentation requirements are reviewed on a case-by-case basis, provided that sound and prudent underwriting practices are followed."[137]

115. Contrary to its representations, Bear Stearns did not exercise any appropriate or meaningful oversight to ensure compliance with the basic risk criteria for prudent and

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[134] BSSLT 2007-1 ProSupp (Group I) at S-31 – S-33; BSSLT 2007-1 ProSupp (Groups II & III) at S-41 – S-44.

[135] SACO 2006-2 ProSupp, at S-36. *See also* SACO 2006-8 ProSupp at S-26; BSSLT 2007-1 (Group I) ProSupp at S-31; BSSLT 2007-1 (Group II) ProSupp at S-41 & S-44.

[136] SACO 2006-2 ProSupp, at S-36 (emphasis added); *see also* SACO 2005-10 ProSupp, at S-31 ("The approval process generally requires that the applicant have good credit history and a total debt-to-income . . . that generally does not exceed 38%; however, this limit may be raised if the borrower demonstrates satisfactory disposable income and/or other mitigating factors are present."); SACO 2006-8 ProSupp, at S-26; BSSLT 2007-1 (Group I) ProSupp, at S-31; BSSLT 2007-1 (Groups II & III) ProSupp, at S-41, S-44.

[137] BSSLT 2007-1 (Group I) ProSupp, at S-29 – S-30; *see also* BSSLT 2007-1 (Groups II & III) ProSupp, at S-41, S-44; SACO 2006-S2 ProSupp, at S-34 – S-35; SACO 2006-8 ProSupp, at S-26.

responsible lending. As has now been revealed, based on its own due diligence and quality control results, Bear Stearns knew prior to consummating the respective Transactions that the underwriting standards were abandoned and borrowers' ability to repay the loans was ignored in order to produce as many loans as possible. This was accomplished, in large part, by turning a blind eye to the systematic inflation of borrowers' patently unreasonable stated incomes, by failing to apply the income reasonableness analysis required by the underwriting guidelines, or by placing clearly ineligible borrowers into loan products like so called "no ratio" or "no doc" loans that did not even require them to state their income to obtain a loan. What the Offering Documents also did not disclose is that exceptions to underwriting standards became the rule and originators routinely deviated from the stated guidelines without establishing any of the compensating factors, which were intended specifically to limit exceptions to qualified borrowers.

116. ***Loan data:*** The Offering Documents also contained detailed appendices purporting to represent critical statistical data for stratified segments of the loan pools, including CLTV ratios, DTI ratios, credit scores, property ownership characteristics, and document-types.[138] These characteristics were used by Ambac and potential investors to evaluate the risks and expected performance of the underlying loan pools for the securities issued in each Transaction. As discussed below, based on its due diligence and quality control, Bear Stearns knew that these loan characteristics, as disclosed in the Offering Documents, were materially false and misleading in that they significantly understated the credit risk of the securitized loans.

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[138] *See* SACO 2005-10 ProSupp, at Schedule A; SACO 2006-2 ProSupp, at Schedule A; SACO 2006-8 ProSupp, at Schedule A; BSSLT 2007-1 (Group I) ProSupp, at Schedule A; BSSLT 2007-1 (Groups II & III) ProSupp, at Schedule A.

117. ***Ratings:*** The Offering Documents provided that "[i]t is a condition to the issuance of the Offered Notes that each class of the Offered Notes be assigned at least the ratings designated" in the ProSupps.[139] For the SACO 2005-10 Transaction, the rating agencies assigned ratings of "AAA" (Standard & Poor's), "AAA" (Fitch), and "Aaa" (Moody's) for the Notes that had the benefit of Ambac's Policy.[140] And for the SACO 2006-2, SACO 2006-8, and BSSLT 2007-1 (Groups 1, II, and III) Transactions, the rating agencies assigned ratings of "AAA" (Standard & Poor's) and "Aaa" (Moody's) for the Notes that had the benefit of Ambac's Policies.[141] These ratings were given in reliance on Ambac's insurance policies, which were obtained by virtue of the fraudulently obtained "shadow ratings" for the Transactions. As discussed above, the represented credit ratings were, thus, materially misleading in that they were fraudulently obtained from the rating agencies on the basis of Bear Stearns' false and misleading representations concerning the characteristics of the securitized loans and Bear Stearns' omissions of material facts regarding its securitization operations and practices. Had Bear Stearns made truthful and complete disclosures to the rating agencies, the shadow ratings, and thus the final ratings, would not have been obtained and the securities backed by the underlying loans could not have been issued, sold, or insured.

118. ***Controls:*** Bear Stearns' statements in the Offering Documents were also false and misleading because they failed to adequately disclose key risks – that the due diligence, quality control, and repurchase protocols touted in its investor presentations and communications with Ambac and investors were severely flawed and that the Transactions were thus replete with

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[139] SACO 2005-10 ProSupp at S-119; SACO 2006-2 ProSupp at S-128; SACO 2006-8 ProSupp at S-88; BSSLT 2007-1 (Group I) ProSupp at S-108; BSSLT 2007-1 (Group II & III) ProSupp at S-164.

[140] *See* SACO 2005-10 ProSupp at S-119.

[141] *See* SACO 2006-2 ProSupp at S-128; SACO 2006-8 ProSupp at S-88; BSSLT 2007-1 ProSupp (Group I) at S-108; BSSLT 2007-1 ProSupp (Groups II & III) at S-164.

defective loans. In the FWP and ProSupp for the SACO 2005-10 Transaction, Bear Stearns assured Ambac and the Note Purchasers (defined below) that EMC's operations "resemble those of most mortgage-banking companies, except that ***significant emphasis*** is placed on the collection and ***due diligence*** areas, due to the nature of the mortgage portfolios purchased."[142] Nowhere in these documents did Bear Stearns disclose that EMC's due diligence and quality control "operations" were frequently circumvented and insufficient to protect Ambac and investors from the risk posed by inherently defective loans conveyed to the securitizations.

119. The Offering Documents for the SACO 2006-2, SACO 2006-8, and BSSLT 2007-1 Transactions were equally false and misleading. In each FWP and ProSupp, Bear Stearns represented that "[p]ortfolios may be reviewed for credit, data integrity, appraisal valuation, documentation, as well as compliance with certain laws" and that "[p]erforming loans purchased will have been originated pursuant to the sponsor's underwriting guidelines or the originator's underwriting guidelines that are acceptable to the sponsor."[143] Bear Stearns concealed that, in fact, its portfolio review inadequately captured defective loans in the securitization, failing to disclose the utter calamity of its due diligence operations as described below.

C. BEAR STEARNS FAILED TO DISCLOSE AND AFFIRMATIVELY CONCEALED MATERIAL FACTS TO INDUCE PARTICIPATION IN ITS SECURITIZATIONS

120. The representations Bear Stearns made concerning its operations and securitizations to induce investors and insurers to participate in its securitizations markedly diverged from Bear Stearns' actual practices. In addition to its materially false and misleading representations regarding the purported securitization policies, Bear Stearns induced Ambac and investors to participate in each of the Transactions by failing to disclose, and affirmatively

[142] SACO 2005-10 ProSupp, at S-33 (emphasis added).

[143] SACO 2006-2 ProSupp at S-39; SACO 2006-8 ProSupp at S-29; BSSLT 2007-1 (Group I) ProSupp at S-35; BSSLT 2007-1 (Groups II & III) ProSupp at S-47.

concealing, that it implemented policies and abandoned controls to churn out securitizations that it knew, or recklessly disregarded, were replete with loans that did not conform with the represented attributes, were originated in total disregard of actual or prudent underwriting standards, and were made without regard to borrowers' ability to repay.

1. Bear Stearns Knowingly Conducted and Concealed "Bad Due Diligence"

121. Bear Stearns intentionally adopted certain due diligence protocols and deliberately rejected others to ensure the uninterrupted flow of loans into its securitizations regardless of the quality of loans securitized. As a result, Bear Stearns breached the disclosures and representations concerning its due diligence protocols despite knowing – and indeed contemporaneously acknowledging – that Ambac and investors relied on Bear Stearns' due diligence because they did not have sufficient time or ability to re-underwrite the loans given the rapid pace of Bear Stearns' securitizations.[144]

122. Bear Stearns' public disclosures and representations regarding its due diligence were materially false and misleading because Bear Stearns did not disclose, among other things, that it (i) knew its internal protocols were flawed, and rejected repeated recommendations to address the flaws, (ii) knew the due diligence firms it retained were not screening out defective loans but did not replace the firms, despite recommendations that it do so, (iii) routinely overrode the defective loan findings of the due diligence firms and, instead of tracking those overrides as was proposed by the head of its due diligence department, deleted the audit trail relating to those override decisions, (iv) knowingly falsified mortgage loan data to avoid defective loan findings,

[144] Email from Ernest Calabrese, Jr. (Bear, Stearns & Co. Managing Director, Mortgage Finance) to John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) among others, dated September 14, 2005, EMC-AMB 001699864-865 ("These parties have been either performing there [sic] own due diligence (usually not enough time) or piggybacking off of the Clayton/Price results."). Haggerty also confirmed that securitization participants relied on Bear Stearns' disclosures as to the scope of due diligence that was performed. 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 155.

and (v) reduced the amount of due diligence conducted to accommodate its suppliers, thereby securing additional loans. Bear Stearns abandoned its due diligence controls to appease its trading desk's demands for increased loan volume for its securitizations, thereby "trading" loan quality for loan volume – which was lucrative for its executives but greatly detrimental to those who relied on its representations.

123. Starting as early as April 2005, well before the close of the earliest Transaction, the head of Bear Stearns' due diligence department (John Mongelluzzo) made repeated entreaties to the Co-Heads of Bear, Stearns & Co.'s Mortgage Finance department in charge of the EMC mortgage-loan conduit (Haggerty and Silverstein) to revise its due diligence protocols.[145] Recognizing that the existing protocols allowed the purchase and securitization of defective loans, Mongelluzzo proposed to rank loans slotted for due diligence by risk criteria and apply incremental resources to the review of each successive gradation of loan.[146] As Silverstein conceded, this proposed change was "significant" and not mere "incremental Darwinian creep" in the evolution of a diligence process.[147] But, Bear Stearns elected *not* to implement this "significant" change to its due diligence protocols in 2005 or in 2006 (when the first three Transactions were closed). Then, in March 2007, Mongelluzzo renewed what he admitted was

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[145] *See*, *e.g.*, Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty and Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Heads Mortgage Finanace), dated April 26, 2005, EMC-AMB 001597507-508 (Proposing "New Due Diligence Processes" including "Identify higher risk loans within sample to DD firms so that more seasoned UW's are reviewing the loans.").

[146] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty and Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Heads Mortgage Finanace), dated May 11, 2005, EMC-AMB 001597504 ("We should also identify the top 25% of loans with the sample that we feel pose the largest risk potential. Both Clayton and PWC upon having those loans tagged/identified can place their most seasoned underwriters to review the loans and also perform additional QC on the loans. Both of these processes are ones that we can use to market our process to investors and the rating agencies going forward.").

[147] 6/4/2010 Silverstein Deposition Tr. at 178; 4/21/2010 Mongelluzzo Deposition Tr. at 172.

the *same* proposal made in 2005, underscoring its import by stating "I think we need to completely revamp how we do due diligence."[148] Mongelluzzo urged the due diligence protocols to be "completely revamped" because it was well known *within* Bear Stearns that the existing diligence protocols were not screening defective loans from the securitizations. As Mongelluzzo and other Bear Stearns executives testified, however, this significant and necessary change to its due diligence protocol – initially proposed in 2005 and renewed in March 2007 – was *not* implemented before the final Transaction in this matter closed on April 30, 2007.[149]

124. Mongelluzzo's proposal to identify and apply increased resources to the review of riskier loans was just one of the many significant due diligence improvements he recommended that were rejected by Bear Stearns' management. In early 2006, Mongelluzzo also proposed that the entire due diligence process be taken away from the due diligence firms used by Bear Stearns (*i.e.*, Clayton and Watterson Prime) and be brought in-house.[150] Mongelluzzo proposed to move the due diligence process in-house because he knew that the diligence firms were not screening out defective loans from the pools purchased for securitization.[151] That was a view shared by Bear Stearns' senior executives.

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[148] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty and Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Heads Mortgage Finanace), among others, dated March 6, 2007, EMC-AMB 001431086 ("Based on that risk score we would determine the type of diligence to be done. The highest level of risk would get the most comprehensive review."); 4/21/2010 Mongelluzzo Deposition Tr. at 174-75.

[149] 4/21/2010 Mongelluzzo Deposition Tr. at 175. In fact, the proposal was never fully implemented, but only on a test-case basis later that year.

[150] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to, among others, Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), dated March 23, 2006, EMC-AMB 001542438-439 (responding to Mongelluzzo's proposal); 4/21/2010 Mongelluzzo Deposition Tr. at 195-96.

[151] As early of May 2005, Mongelluzzo proposed to move the due diligence business away from Clayton because its performance had not been good. *See* Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), among others, dated May 31, 2005, EMC-AMB 005107100-101 ("We should

125. In March 2006, following Mongelluzo's recitation of the failings of the due diligence firms, Verschleiser stated in no uncertain terms that "***we are wasting way too much money on Bad Due Diligence***" conducted by Clayton.[152] Bear Stearns nonetheless rejected Mongelluzzo's proposal and kept the due diligence firms in place. Not surprisingly, therefore, a year later in March 2007, Verschleiser echoed almost verbatim his prior conclusion regarding Clayton Holding's failings, stating ***"[w]e are just burning money hiring them***," a sentiment with which Nierenberg "agree[d]."[153]

126. The issue, as Bear Stearns fully recognized, was that the due diligence firms did not adequately re-underwrite the loans proposed for securitization to assess the borrowers' ability to repay, which was and is a fundamental inquiry under all underwriting guidelines. Accordingly these firms were destined to miss wide swaths of defective loans. Indeed, Verschleiser's denouncement of Clayton in March 2007 – a month before the closing of the BSSLT 2007-1 Transaction – was a direct reaction to a report Mongelluzzo provided that showed the deficiencies of Clayton's findings. The report showed that in 2006 Clayton had reviewed a total of 58,643 loans, but that only 2,078 – or less than 3.5% – were "kicked in the [due] diligence

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look to direct business to Mortgage Ramp from Clayton starting with smaller jobs most preferably (since this is Claytons most expensive job to do for us). Also jobs that are shipped to Clayton might be a good target ***since the performance in their central location has not been as good as we like***."). By the third quarter of 2005, the third party due diligence firms' performance was so bad as to inspire Verschleiser to request EMC to track the material issues they missed. *See* email from Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated November 1, 2005, EMC-AMB 003500070 ("JV has asked us to start logging loans that we believe Clayton or PWC missed material issues on . . . . Linda please start the list with the loans from yesterday and let's keep it on the shared drive.").

[152] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to, among others, Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), dated March 23, 2006, EMC-AMB 001542438-439.

[153] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to, among others, Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), dated March 15, 2007, EMC-AMB 005446200.

process" for defects.[154] As Verschleiser's comment reflects, Bear Stearns knew that the level of defective loans in its pools far exceeded 3.5%. Significantly, the same summary revealed that of those loans rejected, only 310 loans – or just ***0.05%*** of the total loans Clayton reviewed – were identified as having unreasonably stated income. The Bear Stearns executives involved in the exchange, knew that a prevalent defect in its loan pools pertained to borrowers who falsely and unreasonably stated their incomes, but that Clayton had failed to adequately evaluate the reasonableness of the borrowers' incomes. Mongelluzzo admitted as much in an August 2007 response to an inquiry of whether Clayton assessed the reasonableness of income between 2004 and 2006, when he explained that Clayton "***looked at it back then but not as hard***."[155]

127. Bear Stearns had an equally low regard for the adequacy of the review conducted by Watterson Prime and of that firm's ability to identify defective loans.[156] Thus, Mongelluzzo's proposal to bring the due diligence function in-house encompassed the work performed by Watterson Prime.[157] By April 2007, moreover, the problems with Watterson Prime had become so severe that Mongelluzzo advised his team that Bear Stearns "will temporarily cease using them for due diligence services."[158] Rather than disclose these issues in advance of the BSSLT

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[154] *Id.*

[155] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), dated August 30, 2007, EMC-AMB 001433099-100.

[156] *See, e.g.*, Email from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to, among others, Haggerty, Silverstein, Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated December 19, 2006, EMC-AMB 005434366 ("Due to a back log on receiving reports and failure to meet deadlines until further notice, ***do not assign any new trades to Watterson-Prime*** without my prior approval.") (emphasis added).

[157] 6/4/2010 Silverstein Deposition Tr. at 116-17 ("evaluating bringing in-house our due diligence efforts versus outsourcing to Clayton and Prime and other due diligence firms").

[158] E-mail from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to, among others, Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager) and Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager), dated April 13, 2007, EMC-AMB 001747707-708

Transaction, which was scheduled to close two days later, an EMC manager directed the diligence department to "make sure this stays within EMC only."[159] When asked her view of Watterson Prime, the manager who was the point of contact with Watterson Prime recommended that the firm not be hired in the future because "***Watterson~Prime . . . does not always deliver***."[160] And in the words of a former Watterson Prime consultant that conducted due diligence on Bear Stearns loans, "the vast majority of the time the loans that were rejected were still put in the pool and sold."[161] That consultant, who worked at both Watterson Prime and Clayton in performing due diligence of loans purchased by Bear Stearns for securitization, also recently confirmed that Bear Stearns directed its due diligence firms to perform only a cursory review that was little more than a rubber stamp. To comply with Bear Stearns' mandate, Clayton and Watterson Prime instructed their reviewers to grade loans as "level 1", which indicated that the loan met guidelines and should be purchased, even if the reviewer reasonably believed that the borrower did not have the ability to repay the loan or if the stated income seemed unreasonable.[162]

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[159] E-mail from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to, among others, Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations) and Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager), dated April 13, 2007, EMC-AMB 001747707-708.

[160] Email from Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager) to Debbie Rich (EMC Mortgage Corporation, Quality Control), dated July 16, 2008, EMC-AMB 006177517-518 ("Our major issues, ARM issues, prepayment penalty issues, etc., were always WP."); 5/28/2010 Sears Deposition Tr. at 181-188.

[161] 8/28/2010 Warren Deposition Tr. at 46; *see also* Chris Arnold, *Auditor: Supervisors Covered Up Risky Loans*, National Public Radio, dated May 27, 2008, http://www.npr.org/templates/story/story.php?storyId=90840958 (statement from Tracey Warren that "[a]bout 75 percent of the time, loans that should have been rejected were still put into the pool and sold"); Email from Anthony Neske (Watterson Prime LLC) to John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence), dated May 29, 2008, EMC-AMB 005964024-025 (discussing the Waterson Prime employee's public admissions).

[162] 8/28/2010 Warren Deposition Tr. at 36-37 ("Did I see a lot of loans that looked like they were going to be problematic, come down the pike? Yes. Did they meet their guidelines? Unfortunately, yes," but "I saw a lot of loans that were stated and limited documentation loans, which while they met the lenders'

128. Bear Stearns did not disclose to Ambac or the other securitization participants its deep-rooted concerns regarding the failings of its due diligence firms; nor did Bear Stearns adopt Mongelluzzo's proposal to bring the due diligence function in-house to address the failings. At his deposition, Baron Silverstein contended that Bear Stearns rejected the significant change to its diligence structure "because there weren't significant cost savings associated with bringing it in-house."[163] But Bear Stearns' own internal analysis showed a potential cost savings in the year of implementation, $3.6 million in savings in the second year, and $6.7 million annual savings by the fifth year.[164] These escalating cost *savings* were not "significant" enough for Bear Stearns to move away from the *internally*-berated but *publicly*-praised due diligence firms? The truth is that Bear Stearns rejected Mongelluzzo's proposal to bring the due diligence function in-house because the third party due diligence firms provided the false veneer of credibility to the process that Bear Stearns marketed to Ambac and other securitization participants.

129. Revealing of its actual motivation, *i.e.*, to allow the free flow of loans into its securitizations regardless of quality, Bear Stearns also rejected Mongelluzzo's proposal to track the extent and reasons for Bear Stearns' "overrides" of the due diligence firms' conclusions even in those instances where they concluded that loans were defective and should not be purchased. In May 2005, before any of the Transactions at issue had closed, Mongelluzzo requested that Haggerty and Silverstein approve his request "to track loans that are overridden by our due

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guidelines, they cannot necessarily make sense" meaning that "the loans were made to borrowers that . . . did not have a reasonability [sic] to repay."); *id.* at 39 ("There was a high chance that the loan would go into default . . . based on the credit," but although "the borrower likely would not be able to pay," "if it was stated [income] and it met the guidelines, it would be a one.").

[163] 6/4/2010 Silverstein Deposition Tr. at 120-21.

[164] Due Diligence – "Build Initiative" Presentation, dated May 1, 2006, EMC-SYN 00597826-828. *See also* Email from Mongelluzzo to Verschleiser and Nierenberg, among others, dated February 15, 2006, EMC-AMB 001542438-439 ("I ultimately think if we brought all of the DO in house we would run savings of about $6MM annually based on our current DO spend.").

diligence managers and track the performance of those loans."[165] Haggerty previously had been advised by the due diligence department that maintaining the documentation of the due diligence firms' analysis would allow Bear Stearns to track "trends in the reasons for rejection" and for "trades that actually turn into deals determine how different credit performance is for loans that had been flagged as 'exceptions' vs. those that were not."[166] But the particular reasons for its overrides and the "exceptions" it made to underwriting guidelines to allow defective loans to be purchased were exactly what Bear Stearns did *not* want to be tracked.

130. Thus, Bear Stearns did not implement Mongelluzzo's proposal; instead, it did the exact opposite, implementing and maintaining throughout the relevant period a policy that directed its underwriting managers communicating with the due diligence firms to "purg[e] all of the older reports on the trade leaving only the final reports."[167] A Bear Stearns due diligence manager confirmed that, pursuant to this policy, she did not retain copies of the "daily reports" submitted by the due diligence firms.[168] Bear Stearns therefore destroyed evidence and impaired the audit trails concerning the high incidence of Bear Stearns' overrides and waivers leading up to its final purchase decisions.[169]

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[165] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Haggerty and Silverstein, dated May 11, 2005, EMC-AMB 001597504.

[166] Email from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), dated April 25, 2005, EMC-AMB 001699079-080.

[167] *See* Email from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated May 17, 2006, EMC-AMB 004416519-525, at 524 (attaching the EMC Conduit Manual, Bulk Underwriting Chapter, dated April 30, 2005).

[168] *See* Email from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated May 17, 2006, EMC-AMB 004416519-525 at 524 (attaching the EMC Conduit Manual, Bulk Underwriting Chapter, dated April 30, 2005); 5/28/2010 Sears Deposition Tr. at 101-03.

[169] *Id*.

131. What Bear Stearns could not prevent, however, was that one of its due diligence firms – Clayton – would attempt to shield itself from criticism by internally tracking the override decisions made by Bear Stearns. Consequently, Clayton's president had prepared a report that showed that Bear Stearns waived Clayton's findings that defective loans should not be purchased ***up to 65% of the time*** in the third quarter of 2006 alone.[170] Indeed, during the height of its mortgage securitization practice in 2006, Bear Stearns waived an even higher percentage of Clayton's due diligence findings. And, by 2007, Bear Stearns still was waiving one out of every five loans that Clayton rejected.[171]

132. Bear Stearns was thus purchasing loans despite knowing about material defects that Clayton identified during due diligence. For example, Clayton reported that 11% of defective loans that Bear Stearns waived involved "Loan Characteristics [that] do not match any available program."[172] Despite purporting to tighten its controls in the first half of 2007, Bear Stearns did the opposite. The exception Bear Stearns most commonly waived at that time was "Stated Income not [sic] Reasonable"[173] – the very same problem that by August 2007 Mongelluzzo criticized Clayton for not assessing properly.[174] For 2006 and through the first half of 2007, the top five loan defects waived by Bear Stearns related to Terms/Guidelines, Credit

[170] Internal Report produced by Clayton Holdings, Inc., CLAY-AMBACE 0001770-780 at 1777 (showing a 65% override rate for EMC and 56% rate for Bear Stearns in the third quarter of 2006).

[171] All Clayton Trending Reports: 1st Quarter 2006 – 2nd Quarter 2007, published by the FCIC.

[172] Bear Stearns/EMC Trending Report Executive Summary. CLAY-AMBAC-021507.

[173] Bear Stearns/EMC Trending Report Executive Summary. CLAY-AMBAC-021507.

[174] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), dated August 30, 2007, EMC-AMB 001433099-100.

History, Assets, Income/Employment, and Appraisal. All of these are material problems, which should result in a loan being rejected.[175]

133. The common rationale pervading Bear Stearns' due diligence decisions was to ensure that the diligence protocols did not impede, but rather facilitated, the free flow of loans for securitization. This directive was set early and enforced firmly. Thus, as early as February 2005, Haggerty issued the strong directive to *reduce* the due diligence Bear Stearns conducted "in order to make us more competitive on bids with larger sub-prime sellers."[176] As she conceded, reducing due diligence was an accommodation to the suppliers that ensured the flow of mortgage loans that Bear Stearns securitized.[177] Pursuant to Haggerty's directive, Bear Stearns reduced the size of the loan samples it subjected to due diligence and agreed to conduct due diligence *after* the loans were purchased, *i.e.*, "post-closing" due diligence. Both changes reduced the effectiveness of the diligence, and neither was disclosed to Ambac or investors.[178]

134. Consistent with its response to Mongelluzzo's other recommendations, Bear Stearns paid no heed to the warnings by the head of its quality control department regarding the adverse consequences that would result from such limitations. For example, to increase the flow of loans from high-volume originators such as American Home Mortgage (whose lending operations Bear Stearns also helped finance through its warehouse lines of credit), Bear Stearns' trading desk agreed to conduct "post close due diligence" for two loan pools purchased in March

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[175] Bear/EMC Waiver Trending Report by Category, Credit Exceptions, CLAY-AMBAC-021505.

[176] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President of Due Diligence) conveying instructions from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) to reduce due diligence, dated February 11, 2005, EMC-AMB 001718713-714.

[177] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 194.

[178] As Bear Stearns' internal audit department noted, it did not have any "documented process for determining loan sample selections that deviate from the due diligence guidelines," let alone any process for communicating those deviations to securitization participants. Internal Audit Report, dated June 22, 2006, EMC-AMB 010858558-561.

and June 2006.[179] When Mongelluzzo learned of this decision in March, he advised the trading desk and Silverstein that "I would strongly discourage doing post close for any trade with [American Home Mortgage]. You will end up with a lot of repurchases" for defective loans in the securitized pools.[180] Bear Stearns disregarded that advice. Instead, it purchased the two loan pools and quickly packaged over 1,600 loans in the SACO 2006-8 Transaction, making American Home Mortgage the principal originator in the Transaction.[181]

135. Similarly, in February 2007, Mongeluzzo warned Silverstein that "we need to let the desk know and seriously change our sampling percentages."[182] Mongelluzzo's concern stemmed from the large number of defective loans that Bear Stearns' quality control department identified in the securitized loan pools. Again the warning was disregarded, and Silverstein

[179] Email from David Elliott (EMC Mortgage Corporation Deal Manager) to Keith Lind (Bear Stearns & Co. Managing Director, Trading), dated June 23, 2006, EMC-AMB 002314578-579 (describing American Home Mortgage "as turning out to be a post close due diligence"); E-mail from Keith Lind (Bear Stearns & Co. Managing Director, Trading) to John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) and David Elliott (EMC Mortgage Corporation Deal Manager), among several others, dated March 28, 2006, EMC-AMB 001751435-436 ("We will be doing 100% (Credit/Compliance) post closing due diligence on this pool.").

[180] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Keith Lind (Bear Stearns & Co. Managing Director, Trading), David Elliott (EMC Mortgage Corporation Deal Manager), and Baron Silverstein (Bear Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), dated March 28, 2006, EMC-AMB 001751435 (emphasis added). *See also* Silverstein Deposition Tr. at 127-29.

[181] This was not an isolated problem. In March 2006, one of its deal managers observed that Bear Stearns completely abandoned doing any due diligence for flow loans that it had securitized, stating that "on the flow side we had no idea until yesterday that there was post close dd going on. . . . I agree that flow loans were not flagged appropriately and we securitized many of them which are still to this day not cleared. I think the ball was dropped big time on the flow processes involved in the post close dd, from start to finish." Email from Robert Durden (Bear, Stearns & Co. Deal Manager) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated March 24, 2006, EMC-AMB 006802393-395.

[182] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Baron Silverstein, among others, dated February 22, 2007, EMC-AMB 005469676-677.

shortly thereafter proposed to reduce the percentage of loans sampled for GreenPoint, one of the largest originators of defective loans in Bear Stearns' securitizations.[183]

136. In addition to pushing for reduced due diligence, Bear Stearns' trading desk pressured the due diligence department to churn through loans at such a rate as to make any legitimate diligence impossible to attain. For example, on April 4, 2006 – at Verschleiser's behest – EMC's Senior Vice President of Conduit Operations directed her staff to do "whatever is necessary" to meet Bear Stearns' volume objectives:

> I refuse to receive any more emails from [Verschleiser] (or anyone else) questioning why we're not funding more loans each day. I'm holding each of you responsible for making sure we fund at least 500 each and every day. . . . [I]f we have 500+ loans in this office we MUST find a way to underwrite them and buy them. . . . ***I was not happy when I saw the funding numbers and I knew that NY would NOT BE HAPPY. I expect to see 500+ each day. . . . I'll do whatever is necessary to make sure you're successful in meeting this objective***.[184]

Several months later, on September 26, 2006, the same Senior Vice President again ordered her staff to "hit the target number" required by Bear Stearns' trading desk, which required EMC to underwrite and purchase $2 billion in mortgage loans in just one month.[185]

137. The pressure to increase volume at the expense of quality was confirmed by a former EMC mortgage analyst, Matthew Van Leeuwen, who revealed that, among other due diligence abuses, Bear Stearns' focus on loan acquisition was "short term," and that traders

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[183] Email from Baron Silverstein to John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) and others, dated May 29, 2007, EMC-SYN 00416564

[184] Email from Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated April 14, 2006, EMC-SYN 00596927-928 (emphasis added).

[185] Email from Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated September 26, 2006, EMC-SYN 00596855-856 ("I don't understand that with weekend overtime why we didn't purchase more loans today (Monday). . . . ***Our funding needs to be $2 billion this month. . . . I expect to see ALL employees working overtime this week to make sure we hit the target number***.") (emphasis added).

sought to "get cheap loans and sell them at a huge profit margin."[186] A series of emails between the same EMC mortgage analyst, and journalists provides further "disturbing accounts of what was happening behind the scenes" at Bear Stearns.[187] Specifically, in these emails Van Leeuwen admitted that "the pressure was pretty great for everybody to just churn the mortgages on through the system" so that if there were "outstanding data issues . . . analysts would 'fill in the holes.'"[188] As an example, Van Leeuwen explained how "[a] missing credit score would magically become a 680 in Bear's system, things like that."[189] As Van Leeuwen explained in a May 2010 email to journalist Teri Buhl at the *Atlantic*, Bear Stearns' skewed incentives and resulting failures of due diligence affected documentation type data on the mortgage loan tape in addition to credit scores:

> [A] snap decision would be made up there (in NY) to code a documentation type without in-depth research of the lender's documentation standards. . . . [W]e don't want to waste the resources on deep investigation: that's not how the company makes money, that's not our competitive advantage, it eats into profits, etc. If a documentation type, as given by a lender, is erroneous, Bear can point the finger at the lender thanks to indemnification agreements. With that type of protection in this kind of situation, a minimal level of scrutiny is required−and thus ***why worry too much about it? The loans will be off the books soon enough.***[190]

[186] 9/25/2010 Van Leeuwen Deposition Tr. at 86, 110-11

[187] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Nick Verbitsky (Blue Chip Films), dated March 25, 2009, EMC-SYN_VL 0004.

[188] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Nick Verbitsky (Blue Chip Films), dated March 30, 2009, EMC-SYN_VL 0006.

[189] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Nick Verbitsky (Blue Chip Films), dated March 30, 2009, EMC-SYN_VL 0006. *See also* Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Dylan Hoyt (EMC Mortgage Corporation, Due Diligence Underwriter), dated May 16, 2005, EMC-AMB 001718661 (confirming that the EMC analyst was instructed to revise the loan type to a less risky classification).

[190] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Teri Buhl (author of *More Corruption: Bear Stearns Falsified Information as Raters Shrugged*, The Atlantic, May

138. As a result of the foregoing internal practices and policies, Bear Stearns secretly caused large volumes of loans to be pooled into the Transactions without having undergone anything remotely close to the due diligence review protocols publicly touted to Ambac and investors to solicit their participation in the Transactions. The consequences were and continue to be grave.

2. Bear Stearns Covertly Implemented Policies to Securitize Defective Loans

139. With the knowledge that its due diligence protocols were patently inadequate or simply ignored, Bear Stearns' trading desk devised policies to rid its inventory of the toxic loans EMC had acquired by packaging them into securitizations as quickly as possible – *i.e.*, before a default or delinquency occurred that would render the loans "unsecuritizable." Motivated by the huge short-term gains, Bear Stearns increased its securitization volume and pace by covertly revising its internal policies to securitize those loans before they defaulted, as Bear Stearns fully expected they would. That is, in 2005, Bear Stearns quietly revised its protocols to allow for the securitization of loans before the expiration of the "Early Payment Default," or EPD, period, which it defined as the first 30 to 90 days after the loan is acquired from the originator.

140. Bear Stearns' prior policy was to keep loans in its inventory and "not securitize those loans until the early payment default period ran."[191] Because it had recourse against the suppliers of loans that experienced a missed or delinquent payment shortly after origination, seasoning the loans through the EPD period allowed Bear Stearns to cull out and prevent the

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14, 2010), dated May 13, 2010, EMC-SYN_VL 00034-035 (emphases in original removed, emphasis added).

[191] 12/11/09 Durden Rule 30(b)(6) Deposition Tr. at 178-79 ("Q: And for sub prime loan originations and subprime mortgage loans, was it a practice at EMC to not securitize those loans until the early payment default period ran? A: . . . yes . . . "); *see also id.* at 271 ("I believe that a certain point in time the ordinary target date for securitization for certain assets could have been at the expiration of the EPD protection period as well as additional items that could go into that decision making process.").

securitization of loans likely to "contain some form of misrepresentations and [that] should not have been made."[192] Silverstein explained that EPDs (and first payment defaults, or "FPDs") are indicators of fraud or an inability to pay with respect to a loan, suggesting that the loan never should have been granted in the first instance.[193] The former head of Bear Stearns' Fraud Prevention Group concurred, testifying that an "EPD or FPD is an indicator that there could be a possibility of red flags that could eventually be an indicator of misrep[resentation]."[194]

141. Bear Stearns covertly began securitizing loans before the EPD period ran during 2005,[195] and by the end of 2005, the Bear Stearns' trading desk made that practice the rule. On or about December 2005, Verschleiser ordered Bear Stearns' deal managers and traders to start securitizing all "the subprime loans closed in December for the conduit" by January. Because this directive contravened then-existing policy to "typically hold the conduit loans through EPD protection period," when asked if Verschleiser intended to keep this policy in place, a senior Managing Director from the trading desk immediately confirmed: "No, want to see everything regardless of EPDs."[196]

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[192] Bear Stearns Whole Loan Repurchase Project: Repurchases, Current Processes, dated June 21, 2006, EMC-AMB 004919710-740 at p. 30 ("Loans which become delinquent more than 90+ days in their first year. Although a fraud flag can be raised, many such loans contain some form of misrepresentation and should not have been made.").

[193] 6/4/2007 Silverstein Deposition Tr. at 192. The Collateral Analyst for Mortgage Finance at Bear, Stearns & Co. also confirmed that the existence of an EPD "is an indicator of a borrower's ***unwillingness*** to pay their mortgage." 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 275-76 (emphasis added).

[194] 4/15/2007 Gray Deposition Tr. at 113-14.

[195] 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 272-73 ("[I]n the period of time that EMC has held mortgage loans, I am sure that there are instances of mortgage loans being securitized prior to the expiration of the EPD protection period.").

[196] Email from Chris Scott (Bear, Stearns & Co. Senior Managing Director, Trading) to, among others, Robert Durden (Bear, Stearns & Co. Deal Manager) and Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated January 3, 2006, EMC-AMB 001385832-833.

142. Bear Stearns strongly enforced the revised policy. On June 13, 2006, Verschleiser said in no uncertain terms that we need "***to be certain we can securitize the loans with 1 month epd before the epd period expires***."[197] When this directive was not applied, Verschleiser angrily demanded explanations as to why loans "were dropped from deals and not securitized before their epd period expired."[198]

143. While recognizing full well that its revised policy materially increased the riskiness of the loans it securitized, Bear Stearns never informed Ambac or any other participant in the securitizations that Bear Stearns "had changed the policy from not securitizing loans before the EPD period had run to securitizing loans while the EPD period had not run."[199]

144. Because large volumes of securitized loans were beginning to experience delinquencies within the EPD period, Bear Stearns issued repurchase claims against the entities from which it purchased the loans (*i.e.*, the originators). Notably, Bear Stearns did not advise those entities that it no longer owned the securitized loans and that Bear Stearns had yet to incur any loss resulting from the default – to the contrary, it had already generated hefty fees from securitizing the loans. Nor did Bear Stearns assert that it was seeking a recovery on behalf of the securitizations through EMC's role as the loan servicer. Rather, Bear Stearns was silent on the ownership status of the loans. But, rather than require these entities to repurchase a loan that it had already sold, which would necessarily require Bear Stearns to repurchase the loan from the

[197] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head of Mortgage Finance), among others, dated June 13, 2006, EMC-AMB 003993365-367.

[198] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to Baron Silverstein and Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Heads of Mortgage Finance), among others, dated March 1, 2007, EMC-AMB 006087607-616.

[199] *See, e.g.*, 12/11/09 Durden Rule 30(b)(6) Deposition Tr. at 273-74 ("In what I've reviewed, I'm not aware of EMC ever disclosing either of those positions to party external to the firm.").

securitization trust, Bear Stearns would "provide alternatives to repurchase of a loan, such as a price adjustment."[200] As discussed below, Bear Stearns presented other alternatives permitting its recovery for EPD claims while accommodating its suppliers such as cash settlements for a fraction of the repurchase price, "downbids," or other credits for future loan purchases.[201]

145. Bear Stearns' claims activities were not limited to loans experiencing an EPD, but included pursuing and settling claims on securitized loans suffering from other issues, such as fraud or underwriting errors. The significance of these recoveries was underscored as early as August 2005 by a Bear Stearns' representative, who stated:

> "It is very important to try to down bid items rather than have First Horizon buy them back. ***That is how we pay for the lights*****.......**"[202]

Bear Stearns' revised EPD policy thus provided another opportunity to further its fraudulent scheme and to doubly profit from its increased securitization of defective loans.

146. Consistent with that view, an internal presentation prepared for and at the request of Tom Marano for just the one-year period between April 2006 and April 2007, stated that Bear Stearns "resolved claims against sellers pertaining to EPDs in the amount of $1.9 billion," and that the "largest percentage of those resolutions were settlements."[203] The Managing Director that oversaw the preparation of the presentation also admitted that "EPDs were the majority . . . of the volumes of claims that EMC Mortgage Corporation submitted against sellers in 2005 and

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[200] *See*, *e.g.* EMC Claim Form, dated April 6, 2006, EMC-AMB 10534096-98 (claim against Plaza Home Mortgage Financial, Inc. for EPD violation stating "EMC may, at its option, provide alternatives to repurchase of a loan, such as a price adjustment. Please contact your Account Manager if interested.").

[201] *See* Section III.C.6, below.

[202] Email from Brent Giese (Bear, Stearns & Co. Managing Director and Producing Manager of Bear/EMC Correspondent Sales Team) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated August 11, 2005, EMC-AMB 007070103-106.

[203] "EPD Summary" Report, EMC-AMB 004099954; 4/26/2010 Golden Deposition Tr. at 255-56.

2006," and pertained to loans that were in Bear Stearns' securitizations.[204] He further confirmed that, through October 31, 2005, Bear Stearns "resolved claims, the majority of which were EPDs, in the amount of $1.7 billion" and, that in 2006, "$2.5 billion in claims were filed, the majority of which were EPDs."[205]

147. Likewise, when reflecting with hindsight on the success of Bear Stearns' claims practices in 2007, the same Managing Director stated that "***filing these claims hasn't won us any popularity contests but it has saved the firm 100's of millions of dollars in the past***."[206] Following his departure from Bear Stearns in June 2008, he then touted on his resume that this process generated $1.25 billion in recoveries.[207]

148. Bear Stearns never "disclosed to Ambac or other investors that it was recovering on EPDs from originators with respect to securitized mortgage loans, pocketing the money and not putting it into the trust."[208] The Managing Director of Bear Stearns' quality control, claims and representation and warranty departments also could not identify any instance where it "disclosed to Ambac or any other monoline insurer the number of claims with respect to EPDs filed in 2005 and 2006 and thereafter [or] the volume of those claims that were settled in 2006."[209] To the contrary, to perpetuate these recoveries and conceal loans that it knew raised

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[204] 4/26/2010 Golden Deposition Tr. at 120-21.

[205] 4/26/2010 Golden Deposition Tr. at 141.

[206] Email from Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President) to, among others, Leslie Rodriguez (EMC Residential Mortgage Managing Director) and Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims), dated September 15, 2007, EMC-AMB 06870106-110.

[207] 4/26/10 Golden Deposition Exh. 1.

[208] 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 269 ("Q. Well, sitting here today, you can't identify any instance in which EMC or Bear Stearns disclosed to Ambac or other investors that it was recovering on EPDs from originators with respect to securitized mortgage loans, pocketing the money and not putting it into the trust, right? . . . A. Yeah, I'm not aware of a disclosure to Ambac.").

[209] 4/26/2010 Golden Deposition Tr. at 144-45.

"red flags" of fraud and other defects, the manager of repurchase operations admitted that when Bear Stearns recovered on an EPD claim it "would not evaluate the reps and warranties it gave on that very same loan to securitization participants to assess whether there might be other breaches of reps and warranties other than an EPD breach."[210]

149. With this motivation and in view of the substantial recoveries it was able to generate, Bear Stearns then devoted its post-securitization efforts to identifying opportunities to generate recoveries and other benefits from the sellers and originators that supplied ever-growing numbers of defective loans backing its securitizations.

3. Bear Stearns' Quality Control and Repurchase Practices Furthered Its Scheme to the Detriment of the Securitizations

150. As discussed above, Bear Stearns represented to Ambac, rating agencies and potential investors that the securitization participants would benefit from Bear Stearns' "quality control" operations, which re-underwrote loans "post settlement" or *after* Bear Stearns purchased and securitized those loans.[211] Bear Stearns' quality control operations comprised a "production" review undertaken on a randomly selected sample of all loans EMC acquired each month, as well as a comprehensive review of loans that Bear Stearns purchased from new sellers and loans that defaulted within the first year.[212] Bear Stearns reviewed "sample queries of

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[210] 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 94-95. *See also* 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 455 (noting that prior to 2007 when its counsel directed Bear Stearns to change its wrongful practices, "to the extent that EMC obtained a settlement on an EPD claim, it had not subject[ed] those loans to a separate rep and warranty review").

[211] *See* Marketing Decks distributed to Ambac and other potential participants (stating that quality control is a "Post Settlement" review, which includes a "[c]onduit team dedicated to claims of breaches of reps and warrants discovered by the Quality Control group investigations."), discussed in Section III.B.1, above; *see also* 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 179 (confirming that due diligence "was done prior to the settlement of the purchase of the loans, whereas, the quality control reviews were done after EMC settled the purchase of the – of the loan."); 4/26/2010 Golden Deposition Tr. at 17 (confirming that quality control refers to the "post-purchase review of loans that EMC and Bear Stearns securitized").

[212] 4/26/2010 Golden Deposition Tr. at 208-209.

production [to] determine if . . . the underwriter was doing their job and if it was underwritten correctly or there was any defect in the loan."[213] According to Bear Stearns, its quality control department also was responsible for determining whether defective loans complied with the representations and warranties EMC made to Ambac and other securitization participants in the deal documents (referred to as a "securitization breach review").[214]

151. Bear Stearns' commitments to review, identify, and flush out defective loans found after securitization were material to Ambac's participation in the Transactions.[215] Despite marketing its quality control operations for the benefit of Ambac and investors, however, Bear Stearns never disclosed, and deliberately concealed, that its quality control practices were dedicated exclusively to securing for Bear Stearns additional consideration from the entities that supplied Bear Stearns with the toxic loans – to the detriment of the securitizations that were left with the massive risks and losses on the loans.[216] That is, when a securitized loan defaulted

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[213] 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 127. Internal policy documents also establish that Bear Stearns viewed the randomly selected loan samples to provide "the basis for statistical inference (i.e. generalizing from sampled findings to the overall population)," and "[a]s such, they are the most important sample group." *See* EMC's Quality Control Review Guidelines attached to the Contractor Services Agreement between EMC and Adfitech, dated January 26, 2005, EMC-AMB 000229896-918 at 910; 5/20/2010 Serrano Deposition Tr. at 25-27 (acknowledging that "the random sample would be representative of the pool that was purchased that month").

[214] 4/26/2010 Golden Deposition Tr. at 59-60 ("[T]he person who were [sic] QC'ing the loans then made a determination on whether or not it was a securitization breach. . . it was actually the individual who reviewed the loan did the original QC."); *see also* 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 485 (as of December 2005, the department that "reviewed mortgage loans to assess whether or not the loans were in breach of a representation or warranty given by EMC to participants in a securitization," was "done by the quality control department").

[215] March 26, 2007 notes from Gary Gal (Ambac Vice President, MBS Department of Structured Finance) concerning Bear Stearns due diligence call with Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) and Jamie Moy (Bear, Stearns & Co., Mortgage Finance), ABK-EMC03212692 ("When loans goes [sic] delinquent they have external and internal reviewers do a full re-underwrite."). *See also* 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 156-57.

[216] As Mary Haggerty confirmed, when quality control uncovered defective loans, "the first process is the seller has an opportunity to rebut it, provide additional information, et cetera, to see if it could be cured," and if the defect could not be cured, "the claims department would typically issue a repurchase demand to

during the EPD period or Bear Stearns identified a breach in a representation made *to* EMC, Bear Stearns would attempt to negotiate a settlement with the supplier of the loan, and would pocket the recovery. Bear Stearns deliberately decided not to review the defaulted or defective loans identified during quality control for breaches of representations made *by* EMC unless the suppliers demanded to repurchase the loans (and tendered the repurchase funds to EMC) in lieu of settling, an approach the suppliers rarely took (and had little incentive to take) as it was the more costly alternative from their perspective.

152. Reflecting its decision *not* to review defective loans for securitization breaches, Bear Stearns' quality control manager confirmed that until late 2007 there were no "protocols in place to assess securitization breaches with respect to loans acquired through the bulk and flow conduit" (which was the source of the vast majority of mortgage loans at issue).[217] Before then, Bear Stearns limited the securitization breach review to circumstances in which "the seller has already agreed to purchase these loans and then we need to find a reason on these loans to purchase it out of security."[218] In other words, Bear Stearns simply ignored EMC's express representations and warranties requiring prompt disclosure of breaching loans irrespective of Bear Stearns' claims against the sellers of those loans.[219]

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the seller if there was a breach of the a rep and warranty." 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 464, 476-77. No securitization breach was commenced at that time.

[217] 5/20/2010 Serrano Deposition Tr. at 47; *id.* at 44 (noting that as of September 2006, Bear Stearns' securitization breach review "was not something that was executed correctly").

[218] EMC-AMB 010726678. The policies in place as of January 2007 for "reviewing loans for breaches," also provide "[o]nce the lender has confirmed that the they are going to repurchase the loans, it is necessary to buy the loan out of a security if in a deal," EMC-AMB 009649870-076.

[219] *See* Section V.C.1, below.

153. Consequently, despite the substantial number of EPD claims Bear Stearns asserted against the suppliers of the securitized loans,[220] its quality control operations generally did not review those loans for securitization breaches. A Bear Stearns quality control manager revealed Bear Stearns' reasoning: "I don't think we want to do anything with EPDs separate from the 90 Day DQs that are done in the 90 Day DQ shell because ***if we end up keeping the loan we don't want to find a PSA breach***, right?"[221] (The "PSA" is the document in which EMC *made* representations and warranties to the securitizations.) So Bear Stearns deliberately avoided conducting securitization breach reviews for defaulted or defective loans because it did not want to document the breaches it knew existed.

154. The percentage of defective loans Bear Stearns identified through its quality control sampling review was substantial. Bear Stearns contracted with Adfitech, Inc. ("Adfitech") to perform the quality control reviews on its behalf,[222] and instructed Adfitech that the purpose of quality control is "to review loans to evaluate if they meet investor quality guidelines, if sound underwriting judgment was used, and if the loan is devoid of all misrepresentation or fraud characteristics."[223] With this as its directive, Adfitech conducted

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[220] *See* Section III.C.2, above.

[221] Email from Tamara Jewell (EMC Residential Mortgage, Project Manager) to Robert Glenny (EMC Residential Mortgage, Analytics Group/Seller Approval) and Randy Deschenes (EMC Residential Mortgage, CEO), dated July 30, 2007, EMC-AMB 009526626-627.

[222] 5/20/2010 Serrano Deposition Tr. at 22-23 ("Adfitech undertook all the monthly sampling quality control review of loans for the bulk and flow channel of EMC.").

[223] Contractor Services Agreement between EMC and Adfitech, dated January 26, 2005, EMC-AMB 000229896-918 at 909. Bear Stearns reinforced these protocols with Adfitech in its "Loan Origination Quality Control Policy as of February 2007, which expressly stated that the purpose of quality control was to, among other things, "assure that all loans . . . comply with insurer and guarantor requirements," and also called for Bear Stearns to "report to the investor or government agency any violation of law or regulation, false statements, material defect or program abuses within 30 days of discovery." Email from Greg Anderson (Adfitech quality control supervisor) to Sherrie Dobbins (EMC Mortgage Corporation Assistant Manager, Quality Control Underwriting and Vendor Management) and Fernando Serrano (EMC

quality review of samples of loans Bear Stearns acquired. For the period through the end of 2006, Adfitech performed quality control reviews of loans in the Transactions and found that ***38.8%*** to be defective based on Bear Stearns' quality control guidelines. Although these findings revealed material information about the riskiness of loans, and breaches of EMC's representations and warranties (discussed below),[224] at no time before or after the Transactions did Bear Stearns disclose these remarkably high defect rates.

155. Instead, to further its fraudulent scheme and benefit from the securitization of defective loans, Bear Stearns relied on its quality control operations to assert repurchase claims against the entities from which it purchased the loans. Bear Stearns pursued and settled claims against the loan suppliers on the basis that the loans were "not eligible for delivery" without disclosing that it already had sold the loans into a securitization.[225] The discovery of Bear Stearns' files have revealed, to date, almost 4,000 loans in the Transactions for which Bear Stearns made claims against originators but did not repurchase from securitizations.[226] Bear Stearns never disclosed to Ambac or investors that, as demonstrated by its own conduct, these loan were defective.

Mortgage Corp., Quality Control Manager), dated February 2, 2007, EMC-AMB 006975253-267 at 255, 261.

[224] Effectively conceding that the Adfitech quality control findings evidenced securitization breaches, Bear Stearns' Senior Managing Director of the quality control department confirmed that between 2005 through 2006 it applied the same criteria for both of those analyses. 4/26/2010 Golden Deposition Tr. at 104-105.

[225] Bear Stearns' claims correspondence shows that EMC asserted claims against sellers with respect to loans that it had previously securitized in the Transactions on the grounds that "loan was not eligible for delivery to EMC." *See*, *e.g.*, EMC's claim correspondence to American Home Mortgage, dated November 20, 2006, EMC-AMB 004922387 (claim made with respect to four loans previously sold into the SACO 2006-2 Transaction); EMC's claim correspondence to SunTrust Mortgage, dated April 11, 2008, STM-00004433-434 (claim made with respect to one loan previously sold into the BSSLT Transaction).

[226] *See* Whole Loan Inventory Tracking System ("WITS") Database, EMC-AMB 002768454; LMS Database, EMC-AMB1 000007558.

156. By concealing the true nature of its quality control operations and conditioning the securitization breach process on its ability to first recover repurchase funds for itself, Bear Stearns deceived the securitization participants and intentionally interfered with and frustrated EMC's contractual promises to Ambac and investors that it would "promptly" disclose – and within 90 days, cure, substitute, or repurchase – breaching loans from the securitization trusts.

4. The Sheer Magnitude of Defective Loans Bear Stearns Securitized Overwhelmed Its Quality Control and Repurchase Protocols

157. By at least 2006, Bear Stearns had acquired and securitized so many defective and toxic loans that its quality control and claims departments became so overwhelmed that it was unable to process its claims against the entities from which it purchased the loans feeding into its securitization pipeline.

158. The Senior Managing Director at Bear, Stearns & Co. in charge of these departments confirmed being "overwhelmed" by the sheer magnitude of claims it had to file, which had escalated in parallel with Bear Stearns' "rapid increase in the amount loans being purchased and securitized." [227]

159. An internal audit report issued on February 28, 2006 and distributed to senior executives including Haggerty, Cayne, Marano, Mayer, Schwartz, and Spector[228] also confirms Bear Stearns' inability to process its claims, identifying "a significant backlog for collecting from and submitting claims to sellers" consisting of at least 9,000 outstanding claims worth over

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[227] 4/26/2010 Golden Deposition Tr. at 119-20.

[228] Email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department) dated March 7, 2006, EMC-AMB 001496304.

$720 million, and concluding that the procedures in place to process, collect, resolve, and monitor such claims were inadequate or simply non-existent.[229]

160. Despite directing the Senior Managing Director to establish appropriate claims procedures and enhance existing protocols, less than two months later Verschleiser and Haggerty agreed that the "[c]laims situation continues to be a disaster – hitting crisis," because "our operation cannot support the claims collection methodology we have been trying to pursue," and that the Senior Managing Director "clearly continues to be overwhelmed and this is really hurting."[230] Indeed, internal audit reports issued on September 22, 2006 and February 26, 2007 continued to report that many of the issues previously identified in need of correction in early 2006 had yet to be addressed.[231]

161. No one at Bear Stearns disclosed to Ambac that it had acquired and securitized so many defective loans, requiring vast numbers of claims against originators that its internal departments could not handle the workload. The defective loans that Bear Stearns' understaffed departments were able to identify and file claims for represent just a small fraction of the total defective loans that were securitized and would have been identified if the departments had been staffed adequately.

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[229] EMC-AMB 001496305-EMC-AMB 001496311, "Bear Stearns Internal Audit Report – EMC Mortgage Corporation ('EMC') – Review of Representations and Warrants Department."

[230] Emails from Mary Haggerty (Bear, Stearns & Co. Senior Managing Directors, Co-Head Mortgage Finanace) to Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), dated April 18 and April 12, 2006, EMC-AMB 001498898-899.

[231] September 22, 2006 Internal Audit (EMC-AMB 010858575-576) and February 26, 2007 Internal Audit (EMC-AMB 010858610-613), each titled, "Status of Unresolved Audit Report Issues for EMC Mortgage Corporation ("EMC") – Review of Representations and Warrants Department."

5. Bear Stearns Failed to Disclose That Its Counsel and Outside Auditors Found Its Claims Practices Contravened Its Contractual Provisions, Investors' Expectations, and Industry Standards

162. By mid-2006, the growing backlog of repurchase claims had risen to alarming levels, drawing the attention of its external auditors and counsel, which in no uncertain terms issued stern warnings instructing Bear Stearns to revise its claims practices.

163. In August 2006, Bear Stearns' external auditor, PriceWaterhouseCoopers ("PWC"), advised Bear Stearns that its failure to promptly review the loans identified as defaulting or defective was a breach of its obligations to the securitizations.[232] PWC advised Bear Stearns to begin the "[i]mmediate processing of the buy-out if there is a clear breach in the PSA agreement to match common industry practices, the expectation of investors and to comply with the provisions in the PSA agreement."[233] PWC explained that the effect of its proposal "in the Claims work processing flow, is to effectively reverse the current processing order by first considering whether there is a breach of representations and warranties in the PSA agreement and then pursue the claim against the original seller of the loan."[234] The auditor further advised Bear Stearns to promptly remedy its "[l]ack of repurchase related policies and procedures in the Claims, G/L Control and Investor Accounting departments" to comply with SEC regulations.[235]

164. Shortly thereafter, Bear Stearns' legal counsel reinforced PWC's assessment and advised Bear Stearns that it had to revise its improper practices. Haggerty confirmed that, in

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[232] *See* EMC-AMB 006803201-277, "UPB Break Repurchase Project – August 31, 2006."

[233] *Id.* at p. 21.

[234] *Id.* at p. 26.

[235] *See id.* at p. 26 (making reference to Regulation AB, effective January 1, 2006). PWC also recommended that Bear Stearns stop asserting EPD claims to sellers on securitized loans because "an early payment default would not be sufficient cause to buy-back the loan from the security holder. . . . [and] that [Bear Stearns] is processing put-back requests for loans that may not be required to be repurchased out of the security trusts." *See id.* at p. 26. In other words, PWC recognized the incongruity and impropriety of Bear Stearns submitting repurchase demands to suppliers for loans it did not own (*i.e.*, were in the securitizations), but yet had no intention of repurchasing from the securitizations.

early 2007, its counsel advised Bear Stearns that it could no longer keep for itself the substantial monetary recoveries obtained on its EPD and other claims relating to securitized loans, and moreover, that it was required to review the loans for which it obtained recoveries to assess whether the loans breached EMC's representations and warranties made in its securitizations.[236]

165. This legal advice was a recognition, and an admission, that Bear Stearns (i) was not complying with its obligation to review the defaulting or defective loans for which it made claims against suppliers to determine whether they breached representations and warranties EMC extended in the securitization, and (ii) improperly was retaining recoveries on those loans that should be contributed to the securitizations.[237] Indeed, as of August 2006, there were no procedures in place for reviewing the loans subject to settlement agreements or tracking the funds recovered, causing one Bear Stearns employee to admit to "making it up as I go…scary!"[238] Bear, Stearns & Co.'s Executive Director and Assistant General Counsel also confirmed that, before its Legal Department intervened in 2007, no documentation existed setting forth the protocol for disclosing securitization breaches to investors or insurers, such as Ambac.[239] Bear Stearns concealed these issues from Ambac and other securitization participants.

166. Contrary to its own counsel's advice, Bear Stearns did not implement a policy to review promptly defective or defaulted loans for securitization breaches until at least September 2007, long after the last Transaction and only after the defaults on its securities began to rise

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[236] 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. 455-63, 510.

[237] 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. 510; 4/19/2010 Glory Deposition Tr. 125.

[238] Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated August 12, 2006, EMC-AMB 010787527-31.

[239] 1/7/2010 Mesuk Rule 30(b)(6) Deposition Tr. at 115-18.

sharply.[240] According to its employees, moreover, Bear Stearns still has not fully implemented its counsel's advice to contribute to the securitizations the recoveries it obtained on the securitized loans.[241]

167. Instead of promptly making the requisite disclosures and undertaking the appropriate cures, Bear Stearns disregarded the advice given to it and continued to conceal the true nature of its internal operations to induce participation in subsequent transactions, including the SACO 2006-8 and BSSLT 2007-1 Transactions. Bear Stearns also developed ongoing measures to obscure the magnitude of defective loans in its securitizations, and continued to offer concessions designed to maintain its flow of loans from the suppliers of the defective loans.

6. Bear Stearns Made Accommodations to Sellers to Conceal the Volume of Defective Loans and Maintain the Flow of Loans from Those Sellers

168. To perpetuate its fraudulent scheme, Bear Stearns quickly moved to reduce the outstanding claims against the entities from which it purchased the securitized loans by offering them substantial concessions and other accommodations as an alternative to repurchase, which would keep its suppliers happy and ensure the continued flow of loans from these entities available for Bear Stearns to package and bundle in future securitization deals. At the same time, Bear Stearns still managed to secure for itself massive cash recoveries and other benefits on account of toxic loans that it long ago packaged into a securitization.

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[240] *See* Section III.D., below. *See also* E-mail from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to, among others, Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President) and Leslie Rodriguez (EMC Residential Mortgage Managing Director), dated September 13, 2007, EMC-AMB 007176791-800 at 793-94.

[241] 4/19/2010 Glory Deposition Tr. 41 (process not complete as of her departure in Spring 2009); 4/26/2010 Golden Deposition Tr. 142-43 (the policy not fully implemented before he left in Spring 2008). *See also* Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Directors, Co-Head Mortgage Finanace) and John Horner (J.P. Morgan Managing Director, Co-Head of Agency and Non-Agency Trading), dated November 20, 2008, EMC-AMB 011045262-266 at 265 (discussing "***phase I*** of the settlement funds allocation methodology" as part of the Investor Relations Group's ongoing projects) (emphasis added).

169. Although these entities were contractually obligated to buy back defective loans at an agreed-upon repurchase price, by extending more favorable alternatives Bear Stearns could recover an economic benefit from these entities without having to first repurchase defective loans out of a securitization. Moreover, the Senior Managing Director responsible for the claims department confirmed that before offering alternatives to the repurchase of loans that had been securitized, Bear Stearns did not seek the approval or consent of the securitization trust.[242] Indeed, had it done so, Bear Stearns would have alerted the securitization participants to the steadily growing number of loans plagued by material underwriting failures and other fraudulent activities.

170. Accordingly, through EMC, Bear Stearns entered into confidential settlement agreements resolving EPD and other claims in exchange for cash payments at a fraction of the repurchase price "***in lieu of repurchasing the defective loans***."[243] In other instances, Bear Stearns accommodated originators by agreeing to (i) cancel or waive the claims entirely,[244] or (ii) create "reserve programs" that allowed it to use funds from these entities for EPDs violations and other defects by applying them toward future loan purchases. [245] Each of these alternatives

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[242] 4/26/2010 Golden Deposition Tr. at 148.

[243] *See* Section III.F, below.

[244] *See* Emails from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), dated April 18 and April 12, 2006, EMC-AMB 001498898-899 (Haggerty recommends the "immediate cancel of EPD claims for loans that are in deals and are current" after "First Horizon traded a deal away that [EMC] had a 2 tic better bid because [EMC's] EPD claims with them is significantly more than market"); *see also* Email from Brent Giese (Bear, Stearns & Co. Managing Director and Producing Manager of Bear/EMC Correspondent Sales Team), dated February 17, 2005, EMC-AMB 002551279-282 at 279 (noting that originators were complaining about the prevalence of EMC's EPD claims and stating that "at some point will penalize Bear/EMC in terms of not executing business with us if the issues continue").

[245] *See* Email from Paul Nagai (EMC), dated August 7, 2006, EMC-AMB 003637057-058 (The email chain concerns a "new seller claims reserve program being instituted to support sellers with outstanding claims." It states that "This program will allow sellers that have outstanding claims to continue their production activities with Bear Stearns / EMC . . . ."); *see also* 12/11/2009 Durden Rule 30(b)(6)

afforded incremental consideration to Bear Stearns for toxic loans it had already sold to and that remained in the securitization, while at the same time keeping its suppliers happy so as to maintain loan production for inclusion in subsequent securitizations.

171. The limited documentation secured from Bear Stearns to date reveals that it asserted claims against originators for large volumes of defective loans in its securitizations. For example, one report prepared by JP Morgan as late as 2009, lists $575 million worth of loans – including loans in the Transactions – that Bear Stearns put back to originators, ***but did not repurchase from the securitizations.*** Rather, Bear Stearns entered into confidential settlement agreements with the originators to resolve its claims in exchange for monetary payments for just a small fraction (20%) of the total value of the repurchase claims.

172. Bear Stearns did not contemporaneously disclose its practices, or the significant funds it recovered. Instead, breaching loans remained in the trusts and caused continued losses to Ambac and other participants in Bear Stearns' securitizations. EMC initially refused to disclose those agreements in connection with litigation concerning the very loans in dispute here on the grounds that (i) "payments made by sellers to EMC pursuant to the settlement agreements were on a 'lump-sum' basis, without repurchase of any loans, and without allocation of specific amounts to any loans," and (ii) those agreements did not "provide for admissions of liability or substantive resolution of any repurchase claims, apart from simply settling claims relating to populations of loans."[246] EMC's position confirms that settlements were structured in such a way to obfuscate the basis and amounts of the settlement with respective to the particular loans found to be defective. Thus, having deliberately securitized loans it knew represented a high risk

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Deposition Tr. at 290 ("Q. Do you recall that this program was put in place as an accommodation to sellers with large claims so that EMC could continue to collect and obtain mortgage loans from those originators? A. From the language of the Email, it does appear so.").

[246] Letter from EMC's counsel to Ambac's counsel, dated November 6, 2009.

of default or other material failings, Bear Stearns covertly generated significant economic benefits for itself at the expense of Ambac, the Note Purchasers, and other securitization participants.

173. As an accommodation to its suppliers, and to reduce the outstanding claims, Bear Stearns also agreed to allow loans that defaulted during the EPD period, then starting paying again, to remain in its securitization by extending the EPD period.[247] Notably, Bear Stearns' policy allowed it to extend EPD claims against originators with respect to only securitized loans, and expressly forbade such extensions for loans in Bear Stearns' own inventory. Bear Stearns did not want such loans in its inventory because it knew loans that missed payments within the EPD period were very risky and likely to default.[248] In the words of the head of Bear Stearns' quality control department, "the trading desk didn't want to own loans in inventory that had an EPD." [249] So "if the loan was in inventory, an extension agreement wasn't an option" and "the seller had to either repurchase or settle the claim."[250] The differing treatment of loans subject to an EPD illustrates the full extent of Bear Stearns' duplicitous scheme. Even though EPDs raise "red flags" of fraud or other substantive issues causing a borrower to default on his or her initial mortgage payments, Bear Stearns furthered its scheme by quietly agreeing to defer the EPD claim in exchange for other benefits from the loan originator.

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[247] Bear Stearns' policy for extending claims states that "Only loans filed as EPD claims can be considered for an extension. In order for an extension, a loan must be securitized." Email and attachments from Pat Moore (EMC Manager, Representations and Warranties Department) to William Glasgow (EMC Executive Vice President, Loan Administrative Division), dated January 7, 2007, EMC-AMB 009650340-359 at 344.

[248] 6/4/2007 Silverstein Deposition Tr. at 192. *See also* Section III.C.2, above.

[249] 4/26/2010 Golden Deposition Tr. at 151-57.

[250] *Id*.

174. As previewed earlier in connection with its EPD recoveries, Bear Stearns generated billions of dollars in recoveries through these activities. Bear Stearns' internal audit report issued on February 26, 2007 shows that in 2006, Bear Stearns (i) resolved "$1.7 billion of claims, an increase of over 227% from the previous year," and (ii) filed $2.5 billion in claims against the entities originating and selling it defective loans "reflecting an increase of 78% from the prior year."[251]

175. By continuing to offer less expensive alternatives in lieu of an actual loan repurchase through 2007, Bear Stearns generated additional recoveries and benefits in violation of its obligations to review, disclose or repurchase breaching loans from its securitizations.[252] And, by concealing the large volumes of defective loans and keeping the recoveries generated from its undisclosed settlements with originators for itself, Bear Stearns had no economic incentive to honor its securitization practices because then it would have to use its own funds to pay the difference between the repurchase price and the settlement without recourse against the originator. Taking full advantage of this scam, Bear Stearns was able to pocket hundreds of millions of dollars for itself. In 2007 and through the first quarter of 2008, Bear Stearns resolved claims representing $1.3 billion of unpaid principal balance through settlements or other consideration, which provided over $367 million of "economic value that was recovered from

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[251] Bear Stearns Internal Audit Department Escalation Memorandum, titled, "Status of Unresolved Audit Report Issues for EMC Mortgage Corporation ("EMC") – Review of Representations and Warrants Department," dated February 26, 2007, EMC-AMB 010858610-613 at 611.

[252] *See* Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated July 27, 2007, EMC-AMB 006736165-172 (offering "amnesty program" to suspended or terminated sellers by "forgiving claims in exchange for loan production" at reduced pricing); Email from Sharrell Atkins (EMC Mortgage Corp. Assistant Manager, Specialized Fraud Review) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated August 27, 2007, EMC-AMB 006870833 – 834 (extending claim concerning fraud because "SunTrust is an active seller . . . we have issued a 12 month extension").

the sellers."[253] As importantly, it thus continued to foster and financially reward the same type of abysmal origination practices by its sellers that resulted in these defective loans.

7. Bear Stearns Did Not Disclose that It Was Clearing Out Its Inventory by Securitizing Defective Loans While Concealing Its True Assessment of the Securitized Loans

176. Bear Stearns employees were well aware of the poor quality of the loans that were being pooled into its securitizations. Indeed, in August 2006 – one month before the closing date – the deal manager responsible for SACO 2006-8, Nick Smith, referred to the Transaction as a "SACK OF SHIT."[254] Likewise, in earlier correspondence with the Managing Director of the trading desk at Bear, Stearns & Co., this same deal manager characterized the SACO 2006-8 Transaction as a "shitbreather."[255] Not surprisingly, Bear Stearns did not disclose this widespread internal acknowledgment of the poor quality of the loans it was securitizing to investors or Ambac.

177. Moreover, no one at Bear Stearns responded to Nick Smith to correct his characterization of the Bear Stearns' collateral – nor could they, given that they knew the true magnitude of defective loans it intended to securitize. For example, less than two months earlier, an internal review of the loans acquired from American Home Mortgage revealed that less than 22.85% of the loans were current, while up to 60% of the loans had experienced delinquencies of

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[253] 4/26/2010 Golden Deposition Tr. at 63-65 (explaining Bear Stearns' Risk Management Division Report, EMC-AMB 010775342-407).

[254] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager of the SACO 2006-8 Transaction) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated August 12, 2006, EMC-AMB 004377399-400.

[255] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager of the SACO 2006-8 Transaction) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated July 11, 2006, EMC-AMB 002326075-077. In an attempt to explain Smith's characterization of the deal, on direct examination at the June 2, 2010 deposition, Smith incredulously testified that he uses the term "shitbreather" as a "term of endearment." 6/2/2010 Smith Deposition Tr. 211.

30 days or greater (13% were delinquent for longer than 120 days).[256] Rather than disclose this remarkably poor performance, Bear Stearns funneled over 1,600 American Home Mortgage loans into the SACO 2006-8 Transaction, making it the principal originator in the Transaction responsible for the origination of over 30% of the loan pool. Also in advance of the SACO 2006-8 Transaction, Nick Smith and the Bear, Stearns & Co. Managing Director of the trading desk joked about the poor quality of the loans acquired from Just Mortgage, another originator whose operations Bear Stearns financed.[257] Instead of disclosing its true perspective on the loans, Bear Stearns packaged and sold over 1,000 Just Mortgage loans – or just over 19% of the SACO 2006-8 loan pool – when the deal closed a few months later in September.[258]

178. By the start of 2007, to downplay the impact of the deteriorating performance of its prior securitizations in order to keep issuing new ones, Bear Stearns began publicly touting its efforts to improve the quality the loans it was securitizing by (i) "tightening" underwriting standards, in many respects to "emphasize" the controls that it should have had in place all along and (ii) "downgrading' originators within its network consistently selling the worst performing loans to "suspended" or "terminated" status as a means to prevent and limit the securitization of loans from those third parties. To this end, in March 2007, Bear Stearns employees informed

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[256] Email from Judy Duffek (EMC Mortgage Corporation Associate Vice President, Seller Review & Approval) to Randy Deschenes (EMC Residential Mortgage CEO and Managing Director), EMC-AMB 006740876-877 at 877 (recommending that Bear Stearns "discontinue purchase of 2nd liens from this client or bid to miss since this seems to be the product that they have the most problem with which are not returning value.").

[257] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated June 30 2006, EMC-AMB 002319215-216 (sarcastically asserting that "Everyone loves their loans"). *See also* Email from Nicholas Smith to Keith Lind, dated June 29 2006, EMC-AMB 002317084-085 (noting that another insurer would not participate "even if we pull the Just Mtg. Population").

[258] Reflecting the issues with the Just Mortgage loans, in the email chain in which he referred to the 2006-8 Transaction as a "shit breather", Nick Smith specifically highlighted for Keith Lind and Silverstein that the pool would be "including the Just Mtg population." Email from Nicholas Smith to Keith Lind, dated July 11, 2006, EMC-AMB 002326075-077 at 075.

Ambac that "there has been significant improvement in the collateral pool itself [for BSSLT 2007-1],"[259] and pushed Ambac's credit underwriters to speak with Verschleiser to discuss the "originators and correspondents we actually kicked out of the program, which should also be a major difference."[260]

179. Bear Stearns knew quite well – but did not disclose – that its inventory still was overridden with defective loans purchased from the worst performing originators in its network.[261] Rather than accept the consequences of having already purchased these loans through its own bad processes and procedures, Bear Stearns unilaterally decided to ***stop performing post-purchase quality control on loans purchased from suspended or terminated sellers*** to buy time for its trading desk to clear out its pipeline of defective loans.[262]

180. Bear Stearns changed this policy without informing the participants in its securitizations. Although its securitizations, including the SACO Transactions, were filled with loans purchased from terminated or suspended sellers, Bear Stearns did not disclose its decision to discontinue the seller monitoring and quality control operations it represented it would

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[259] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 30, 2007, ABK-EMC01536356.

[260] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 30, 2007, ABK-EMC01536369-370.

[261] *See, e.g.*, Bear Stearns' seller "Watch List" as of February 27, 2007, EMC-AMB 005042831-839 at 837 (identifying at least 48 sellers with "D" of "F" grades that originated at least 1,680 loans later securitized in the BSSLT 2007-1 Transaction); Email from Julio Chong (EMC Mortgage Corp., Business Information) dated March 28, 2007, EMC-AMB 010346044-045 (identifying over 40 "high risk" sellers "to be cut off by 3/30/07" based on high loss severity in securitized loans, 20 of which originated over 2,800 loans later securitized in the BSSLT 2007-1 Transaction).

[262] 5/20/2010 Serrano Deposition Tr. 180-184; E-mail from Norton Wells (EMC Mortgage Corp. Executive Vice President, Quality Control) to, among others, Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), and Fernando Serrano (EMC Mortgage Corp., Quality Control Manager), dated April 18, 2007, EMC-AMB 006009144-145 ("Loans from these [Terminated, Suspended and "F" rated] Sellers are being excluded from sampling per instructions.").