116. Ambac required and relied on these tapes as a critical component in deciding whether to provide insurance for the Transactions, 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. Ambac used the data on the tapes as inputs to its risk models, and analyzed the loan metrics, which were central to assessing the risk associated with the loan pools 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 loan-to-value ratio ("LTV") for each loan, which measured the 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 that borrowers were required to disclose concerning their income, employment, and assets, and how such information would be verified.

117. 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.[78]

118. Owner-occupancy statistics were material to Ambac and other investors because homeowners who reside in mortgaged properties are less likely to default (which would result in eviction from their homes) than owners who purchase homes as investments or second homes and live elsewhere. Indeed, internal Ambac memoranda for the Transactions list the percentage

[78] Ambac Amended Complaint ¶ 92 (citing 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).

of "non-owner occupied" properties or "investor properties" in a given loan pool as among the related Transaction's "Weaknesses" or "Risks."

119. Likewise, LTV ratios were material to Ambac and other investors because higher LTV ratios are correlated with a higher risk of default. A borrower with a small equity position in a property has less to lose if he or she defaults on the loan. Additionally, the higher the LTV ratio, the greater the likelihood that a foreclosure will result in a loss for the lender. LTV ratio is a common metric for analysts and investors to evaluate the price and risk of mortgage-backed securities.

120. DTI ratios were material to Ambac because the higher the borrower's DTI ratio, the greater the risk that the borrower will have difficulty repaying the loan.

121. In light of the recent revelations about Bear Stearns's due-diligence and quality-control practices, it is clear that Bear Stearns fully understood the failings of those controls and, therefore, knew that the loan tapes contained false and misleading data – or recklessly disregarded the veracity of the disclosures. Indeed, Ambac's recent loan-level reviews of loans in the Transactions have confirmed that the loan tapes contained materially false and misleading data.

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

122. 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. 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.

123. Bear Stearns knew that these disclosures were critical to Ambac's assessments of the risks and, ultimately, Ambac's decision to issue its Policies in connection with the Transactions. Specifically, it knew that Ambac considered and evaluated Bear Stearns's disclosures concerning the performance of comparable loans in previous Bear Stearns securitizations in order 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.[79]

124. 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, quality-control, and EPD-repurchase 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 future Transactions. To the contrary, 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 investors into participating in Bear Stearns's securitizations, including the Transactions.

[79] Ambac Amended Complaint ¶ 95 (citing 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).

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

125. Bear Stearns provided false and misleading information to the rating agencies, Standard & Poor's and Moody's, 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. A final rating is an assessment of the value or risk of the security taking the financial-guaranty policy into consideration. Bear Stearns knew full well that Ambac used the shadow ratings in deciding whether and on what terms to participate in the Transactions. The commitment letters for each Transaction specified the shadow ratings that were a condition precedent to Ambac's issuance of its Policies.

126. 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 Certificates expressly stated that a final rating was a condition precedent to Bear Stearns's offering of the securities.

127. For each of the Transactions, Ambac received both shadow and final ratings that were derived from information supplied to the rating agencies by Bear Stearns. 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 Ambac, including marketing presentations, loan tapes, and Offering Documents.

128. 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 Policies, which were obtained by virtue of the fraudulently obtained shadow ratings. These ratings therefore added another critical layer of false assurances to investors and Ambac 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 Used to Market and Sell the Certificates

129. Bear Stearns marketed the securities issued in its securitizations, including the Transactions, pursuant to Offering Documents[80] 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 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.

130. The Registration Statements and 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. 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. The drafts contained false and misleading statements and omissions similar to those made in the Offering Documents eventually filed with the SEC.

131. 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 these

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[80] The Offering Documents are defined above to include the Registration Statements, FWPs, Prospectuses, and ProSupps.

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 and were not underwritten in accordance with the underwriting standards represented in the Offering Documents.

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

133. ***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 to ensure the quality of all of the loans in the Transactions. For example, the ProSupp for the SAMI 2006-AR7 and SAMI 2006-AR8 Transactions disclosed that Countrywide originated its loans, which constituted 100% of the loans in the SAMI 2006-AR7 Transaction and approximately 52% of the loans in the SAMI 2006-AR8 Transaction, pursuant to underwriting standards designed to "evaluate the prospective borrower's credit standing and repayment ability, and the value and adequacy of the mortgaged property as collateral."[81] The ProSupps for the GPMF 2006-AR2 and GPMF 2006-AR3 Transactions contain identical language with respect to GreenPoint, which originated 100% of

[81] SAMI 2007-AR7 ProSupp at S-45; SAMI 2006-AR8 ProSupp at S-49.

the loans in each of those deals.[82] And the ProSupps for the BSMF 2006-AR2 and BSMF 2006-AR4 Transactions contain similar language with respect to BSRM, which originated the majority of the loans in those deals.[83]

134. 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 ProSupps for the BSMF 2006-AR2 and BSMF 2006-AR4 Transactions assured Ambac and investors that a reasonableness standard guided BSRM's review of "exception loans," which were "managed through a formal exception process" as follows:

> Exceptions to the BSRM Underwriting Guidelines are considered ***with reasonable compensating factors on a case-by-case basis and at the sole discretion of senior management***. When exception loans are reviewed, all loan elements are examined as a whole to determine the level of risk associated with approving the loan including appraisal, credit report, employment, compensating factors ***and borrower's willingness and ability to repay the loan***.[84]

135. The Offering Documents also describe the originators' various loan products, including so-called "low doc" or "no doc" loans, or those that require less documentation from the borrower regarding his or her income and assets than "full doc" loans require. Bear Stearns assured Ambac and investors that these types of loans – which constitute the overwhelming majority of the loans in the Transactions – were limited to prime borrowers, or those "with excellent credit histories," as the description of Countrywide's underwriting guidelines in the SAMI 2006-AR7 and SAMI 2006-AR8 ProSupps explains.[85] The description of GreenPoint's

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[82] GPMF 2006-AR2 ProSupp at S-33; GPMF 2006-AR3 ProSupp at S-29.

[83] BSMF 2006-AR2 ProSupp at S-35; BSMF 2006-AR4 ProSupp at S-27.

[84] BSMF 2006-AR2 ProSupp at S-36; BSMF 2006-AR4 ProSupp at S-27 (emphasis added).

[85] SAMI 2006-AR7 ProSupp at S-49; SAMI 2006-AR8 ProSupp at S-53.

underwriting guidelines in the GPMF 2006-AR2 and GPMF 2006-AR3 ProSupps likewise explains that "[m]ortgage loans underwritten under this type of [limited-documentation] program are generally limited to borrowers with credit histories that demonstrate an established ability to repay indebtedness in a timely fashion."[86] The guidelines descriptions in the ProSupps also include assurances that for "stated income" loans – in which the borrower states his income and the lender does not independently verify it – ***underwriters are required to confirm the reasonableness of the stated incomes***.[87]

136. The Offering Documents also discuss the originators' policies with respect to appraisals, which, as noted, directly inform the LTV ratios on which Ambac and other investors relied in deciding to participate in the Transactions. In particular, Bear Stearns represented in the Offering Documents that one or more ***independent*** appraisals were obtained for nearly every loan in the Transactions. For example, in the ProSupps for the SAMI 2006-AR7 and SAMI 2006-AR8 Transactions, Bear Stearns represented as follows with respect to Countrywide's appraisal practices:

> Except with respect to mortgage loans originated pursuant to its Streamlined Documentation Program, whose values were confirmed with a Fannie Mae proprietary automated valuation model, Countrywide Home Loans obtains appraisals from independent appraisers or appraisal services for properties that are to secure mortgage loans. The appraisers inspect and appraise the proposed mortgaged property and verify that the property is in acceptable condition. Following each appraisal, the appraiser prepares a report which includes a market data analysis based on recent sales of comparable homes in the area and, when deemed appropriate, a replacement cost analysis based on the current cost of constructing a similar home. All appraisals are required to

[86] GPMF 2006-AR2 ProSupp at S-33; GPMF 2006-AR3 ProSupp at S-30.

[87] *See, e.g.*, BSRM 2006-AR4 ProSupp at S-29 ("The applicant's income as stated must be reasonable for the related occupation, borrowers' credit profile and stated asset, in the loan underwriter's discretion.").

> conform to Fannie Mae or Freddie Mac appraisal standards then in effect.[88]

The ProSupps for the GPMF 2006-AR2 and GPMF 2006-AR3 Transactions include similar language with respect to GreenPoint's appraisal practices, including that "[i]n determining the adequacy of the property as collateral, an independent appraisal is generally made of each property considered for financing."[89] These representations regarding appraiser independence were material to Ambac and other investors because, among other things, they are important indicators of the reliability of the LTV ratios discussed above.

137. 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 responsible lending. As has now been revealed, based on its own due-diligence and quality-control results – including results provided to it by Clayton in so-called "Ttrending Reports" – Bear Stearns knew prior to consummating the respective Transactions that the originators' underwriting standards were abandoned and that 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 both appraisal values and borrowers' patently unreasonable stated incomes, by failing to require adherence to the applicable 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.

138. Specifically with respect to appraisal practices, Bear Stearns failed to disclose in the Offering Documents that – contrary to its representations – during the time period of the Transactions, it regularly found evidence of inflated and fraudulent appraisals in the loans it

[88] SAMI 2006-AR7 ProSupp at S-46; SAMI 2006-AR8 ProSupp at S-50.

[89] GPMF 2006-AR2 ProSupp at S-34; GPMF 2006-AR3 ProSupp at S-30.

securitized. When asked what the most common loan defects were from 2003 to 2007, Haggerty began by telling the FCIC, "I think what one would typically see would be things like the appraised value of the property was misstated."[90]

139. What the Offering Documents also did not disclose is that exceptions to underwriting standards became the rule and that the originators Bear Stearns bought loans from, under pressure from securitization sponsors like Bear Stearns, routinely deviated from the stated guidelines without establishing any of the compensating factors, which were intended specifically to limit exceptions to qualified borrowers.

140. ***Loan data:*** The Offering Documents also contained detailed appendices purporting to represent critical statistical data for stratified segments of the loan pools, including LTV ratios, credit scores, occupancy characteristics, and documentation types.[91] 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.

141. ***Ratings:*** The Offering Documents provided that "[i]t is a condition to the issuance" of the Certificates that they receive the ratings from Standard & Poor's and Moody's set forth in the ProSupps. For each of the Transactions, the rating agencies assigned ratings of "AAA" (Standard & Poor's) and "Aaa" (Moody's) to the Certificates that had the benefit of Ambac's policy. These ratings were given in reliance on Ambac's policies, which, as noted,

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[90] February 24, 2011 FCIC Interview with former Bear Stearns Senior Managing Director Mary Haggerty, Tr. at 32.

[91] *See* ProSupps Schedule A, except in the context of the BALTA 2006-R1 Transaction, whose ProSupp Schedule A contains statistical data on the underlying certificates (as opposed to the loans).

were obtained by virtue of the fraudulently obtained "shadow ratings" for the Transactions. As discussed above, the represented credit ratings were materially misleading in that they were fraudulently obtained from the rating agencies on the basis of Bear Stearns's false and misleading representations concerning the characteristics of the securitized loans and Bear Stearns's 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 Ambac would not have issued its Policies.

142. ***Controls:*** Bear Stearns's 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 defective loans. In the ProSupp for each Transaction, 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."[92] Bear Stearns concealed that, in fact, guidelines for the loans in its securitizations were completely abandoned during the underwriting process and that, to compound the problem, Bear Stearns's purportedly robust due-diligence operations did not identify and remove defective loans from the securitizations.

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[92] *See* GPMF 2006-AR2 ProSupp at S-29; GPMF 2006-AR3 ProSupp at S-26; BSMF 2006-AR2 ProSupp at S-30; BSMF 2006-AR4 ProSupp at S-22; SAMI 2006-AR7 ProSupp at S-37; SAMI 2006-AR8 ProSupp at S-39; BALTA 2006-AR1 ProSupp at S-30.

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

1. Bear Stearns's Representations Concerning Its Due Diligence Were Knowingly False and Misleading

143. In advance of the Transactions, and to induce Ambac to issue its Policies, Bear Stearns knowingly made materially false and misleading statements – at investor conferences, in investor presentations, and in private meetings between Bear Stearns and Ambac, as noted – about the scope and integrity of the due-diligence protocols purportedly in place for Bear Stearns to review loans prior to acquiring them from originators or including them in Bear Stearns's securitizations, and in the Transactions in particular. Contrary to Bear Stearns's representations to Ambac that the due-diligence process entailed a robust loan-file audit to assess whether the loans complied with the applicable underwriting guidelines and federal and state law – including in particular, as noted, reviews for "credit, data integrity, appraisal valuation, and documentation" – Bear Stearns had designed the due-diligence process to permit the acquisition and securitization of defective loans.[93] As has been revealed by numerous confidential witnesses, the pre-acquisition due-diligence process was highly flawed and fraudulently manipulated by Bear Stearns.

144. Bear Stearns knew – and indeed contemporaneously acknowledged – that financial-guaranty insurers, including Ambac, relied on Bear Stearns's due-diligence disclosures because they did not have a reasonable opportunity to review individual loan files given, among

[93] A former Watterson Prime due-diligence consultant who reviewed loans for Bear Stearns, Tracy Warren, confirmed during deposition testimony in connection with Assured's lawsuit against Bear Stearns that Watterson Prime's due-diligence review was nothing more than a rubber stamp of originators' findings to satisfy the "client's" – Bear Stearns's – objective of purchasing a large volume of loans for securitization. *See* Assured Complaint ¶ 166 (citing 8/25/2010 Warren Deposition Tr. at 41-43 (Q. "So, [your supervisors] were aware that there were issues with respect to the borrowers' ability to pay, but they told you to focus on technical compliance with the guidelines as stated?" (over objection) A. "Yes.")).

other things, the rapid pace of Bear Stearns's securitizations.[94] Moreover, Bear Stearns knew that insurers like Ambac relied on Bear Stearns's due diligence because there was a fundamental asymmetry of information between the parties. That is, Bear Stearns – not the insurer – was in privity with the loan seller and had access to the loan files needed to perform due diligence, which took place at the time Bear Stearns acquired mortgage loans from sellers, not at the time of securitization. But Bear Stearns made the above representations and disclosures regarding its due-diligence protocols with knowledge that they were false and materially misleading when made or with reckless disregard as to their truth.

145. More specifically, Bear Stearns knew that its due-diligence practices did not screen out defective loans with respect to loans from originators included in the Transactions, including, for example, GreenPoint. As revealed in Assured's lawsuit, on August 29, 2005 – two months before the transaction on which the GPMF 2006-AR2 was based – Bear Stearns personnel suggested that Bear Stearns use "more due diligence up front" in order to avoid "what has happened on the past Greenpoint deals."[95] Bear Stearns failed to disclose to Ambac its contemporaneous knowledge about the failings of its due diligence on GreenPoint deals.

146. Before the GPMF 2006-AR2 and GPMF 2006-AR3 Transactions closed, Bear Stearns also knew that due diligence was of increased importance because its own monitoring of

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[94] Assured Complaint ¶ 172 (citing email from Ernest Calabrese, Jr. (Managing Director, Mortgage Finance, Bear, Stearns & Co.) to John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) among others, dated Sept. 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."); and noting that Haggerty also confirmed that securitization participants relied on Bear Stearns's disclosures as to the scope of due diligence that was performed. 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 155; email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Pattie Sears (Due Diligence Manager, EMC Mortgage Corporation) and Jose Carrion (EMC Mortgage Corporation Subprime Underwriting Manager), dated March 23, 2005, EMC-AMB 001699111).

[95] *See* Assured Complaint ¶ 173 (citing email from Patty Lester (EMC Mortgage Corporation, Vice President, Special Loans) to Janet Gonzales (EMC Mortgage Corporation, Vice President, Trading), dated Aug. 26, 2005, EMC-AMB 008918775).

GreenPoint revealed a high percentage of underwriting failures and other defects.[96] GreenPoint even told Bear Stearns's head of due diligence that it was "selling everything under the sun."[97] In July 2005, Bear Stearns traders and executives internally commented on the unusually high risk and poor quality of the loans in a GreenPoint transaction, showing their surprise that GreenPoint approved up to "40% of first time home buyer with no down payment wow!"[98] Nonetheless, Bear Stearns purchased and securitized these high-risk loans in the GPMF 2006-AR2 and GPMF 2006-AR3 Transactions knowing that the need for effective due diligence was even more critical, but that such due diligence was non-existent.

147. The falsity of Bear Stearns's fraudulent scheme is corroborated by statements by dozens of former employees of Watterson Prime and Clayton. As noted, Watterson Prime and Clayton were the two vendors that, according to Bear Stearns's representations to Ambac, conducted pre-closing due diligence on loans for securitization. The confidential witnesses confirm that the farce that was Watterson Prime's and Clayton's re-underwriting due-diligence process was in many ways the result of Bear Stearns's express directives. These witnesses include (i) Clayton and Watterson Prime "team leads," who were assigned to manage individual due-diligence-review projects and reported directly to and received instructions from Bear Stearns's due-diligence managers, (ii) underwriters, who were hired on a contract basis to review the loan files and received their instructions from the team leads, (iii) "quality control" underwriters, who purportedly conducted quality-control review of the underwriters and received

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[96] *See* Assured Complaint ¶¶ 14, 121, 209.

[97] *See* Assured Complaint ¶ 174 (citing email from Dianne Hill (GreenPoint) to John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence), dated July 13, 2005, EMC-ASSURED 000482090).

[98] Assured Complaint ¶ 174 (citing email exchange between Scott Eichel (Bear, Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading) and Jeff Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), dated July 6, 2005, EMC-ASSURED 000480417).

their instructions from the team leads, and (iv) underwriters employed by the "trailing docs" department, which purportedly ensured that documents missing from loan files subject to due-diligence review were obtained from the sellers.

148. These confidential witnesses corroborate that Clayton and Watterson Prime followed Bear Stearns's directives to, among other things, re-underwrite the loans in a substandard manner and code defective loans as non-defective:

- ***Clayton and Watterson Prime overlooked defects at the direction of Bear Stearns:*** The confidential witnesses state that they were directed to overlook defects and to grade defective loans as non-defective. Several team leads, who communicated directly with Mongelluzzo and Patti Sears (Co-Head of Due Diligence), confirmed that they were directed by Mongelluzzo and Sears to overlook defects in loans. For instance, according to the team leads, when Clayton and Watterson Prime discovered defects related to compliance issues, they were instructed by Mongelluzzo and Sears that Bear Stearns had already priced the defects into the amount it paid to the originator. As such, the team leads directed the underwriters to grade these defective loans as non-defective. The underwriters complied with these instructions.

- ***At the direction of Bear Stearns, Clayton and Watterson Prime rubber-stamped unreasonable stated incomes:*** The confidential witnesses state that although they often found the incomes listed on stated-income loan applications to be unreasonable, they were directed by their supervisors and Bear Stearns to grade such loans as non-defective. According to the team leads, when they discussed unreasonable stated incomes with Mongelluzzo and Sears, the Bear Stearns managers replied, "we are not worried about it" and "it's priced in the pool."

- ***Bear Stearns directed Clayton and Watterson Prime to overlook fraudulent loans:*** The confidential witnesses state that they were directed not to look for fraud in the loan files and to overlook any fraudulent documents found in the loan files. The team leads state that when they notified Mongelluzzo and Sears that Clayton and Watterson Prime had discovered fraud in loans, they were directed to grade such loans as non-defective if fraud was the only defect.

- ***At the direction of Bear Stearns, Clayton and Watterson Prime used contrived compensating factors:*** The confidential witnesses state that they were directed by their supervisors and Bear Stearns to cite compensating factors, even ones that they believed were insufficient to overcome the defects. The team leads state that they were likewise directed by Mongelluzzo and Sears to cite compensating factors that they believed were insufficient to overcome defects, and they conveyed these instructions to Clayton and Watterson Prime underwriters. The underwriters complied with these instructions.

- ***Bear Stearns directed Clayton and Watterson Prime to utilize a "5 percent tolerance":*** According to the confidential witnesses, they were directed to utilize a "tolerance" of 5 percent with respect to certain ratios, such as DTI, LTV, and CLTV. That is, Clayton and Watterson Prime were directed by Bear Stearns to grade a loan as non-defective so long as the DTI, LTV, and CLTV ratios for that loan did not exceed the maximum ratios permitted by underwriting guidelines by more than 5 percent. In other words, they were effectively directed to apply different guidelines. The team leads state that they received these instructions from Mongelluzzo and Sears and conveyed them to the underwriters. The underwriters complied.

- ***Bear Stearns directed Clayton and Watterson Prime to change grades on defective loans to reflect that they were not defective:*** The team leads state they were directed by Mongelluzzo and Sears to improperly re-grade defective loans as non-defective. The team leads passed these instructions on to quality-control underwriters, who implemented the grade-changing scheme.

- ***Clayton and Watterson Prime underwriters coined the phrase "Bear Don't Care":*** The confidential witnesses state that underwriters used the phrase "Bear don't care" to describe Bear Stearns's attitude towards the due-diligence-review process.

149. As these witnesses' accounts about the practices at Watterson Prime and Clayton confirm, Bear Stearns furthered its fraudulent scheme by secretly pooling a large volume of loans into the Transactions without their having been subject to anything remotely close to the due-diligence protocols that Bear Stearns touted to Ambac to induce its participation in the Transactions.

2. Bear Stearns Knowingly Conducted and Concealed Its Substandard Due-Diligence Practices

150. Bear Stearns's disclosures and representations regarding its due diligence were materially false and misleading because Bear Stearns knew, but deliberately concealed, that the due-diligence firms it retained were directed not to screen out defective loans to prevent their securitization. Tellingly, Bear Stearns senior management rejected repeated recommendations from more junior-level due-diligence personnel to address observed problems and, as discussed above, intentionally implemented protocols designed to falsify the due-diligence results and

conceal from securitization counterparties even those defects that its due-diligence firms had identified.

151. For example, according to an internal Clayton "Trending Report" made public in September 2010, in the period from the first quarter of 2006 to the second quarter of 2007 – *i.e.*, when all of the Transactions were effectuated – 16% of the loans in RMBS loan pools that Bear Stearns submitted to Clayton for review were rejected by Clayton as falling outside the applicable underwriting guidelines. Of the loans that Clayton found to be defective, however, 42% were subsequently "waived in" by Bear Stearns without proper consideration and analysis of compensating factors and included in securitizations such as the Transactions at issue here.[99]

152. Thus, Bear Stearns ensured that the due-diligence protocols facilitated, and did not impede, the free flow of loans for securitization. This directive was set early and enforced firmly. In February 2005 – at the same time Bear Stearns was touting its due-diligence practices to Ambac – Bear Stearns's Co-Head of Mortgage Finance, Mary Haggerty, gave explicit directions to reduce the amount of due diligence "in order to make us more competitive on bids with larger sub-prime sellers."[100] Haggerty has since admitted that limiting the due diligence was an accommodation to suppliers that Bear Stearns relied on to ensure the flow of mortgage loans available and necessary for its securitizations.[101]

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[99] *See* "All Clayton: Trending Reports, 1st Quarter 2006 – 2nd Quarter 2007," *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0923-Clayton-All-Trending-Report.pdf.

[100] Ambac Amended Complaint ¶ 133 (citing email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) conveying instructions from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) to reduce due diligence, dated Feb. 11, 2005, EMC-AMB 001718713-714).

[101] Assured Complaint ¶ 190 (citing 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 194; 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 251-52 ("Q. Was it your understanding that in February 2005 that EMC reduced the amount of due diligence it was undertaking in order to make it more competitive on bids with large subprime sellers? . . . A. It does appear as though they did.")).

153. Recognizing that the existing protocols allowed the purchase and securitization of defective loans, in April 2005, Mongelluzzo repeatedly advised the Co-Heads of Bear Stearns's mortgage-finance department (Senior Managing Directors Haggerty and Silverstein) to revise due-diligence protocols. Mongelluzzo proposed to rank loans slotted for due diligence by risk criteria and apply additional resources to the review of each successive gradation of loan.[102] Silverstein conceded that this proposed change was "significant" and not mere "incremental Darwinian creep" in the evolution of a due-diligence process.[103] As Mongelluzzo and other Bear Stearns executives have testified, however, Bear Stearns did not implement this change – or any significant change – to its due-diligence protocols prior to the closing of the Transactions.[104] In fact, although Mongelluzzo renewed his proposal to allocate greater resources to riskier loans almost two years later, when Bear Stearns recognized that its scheme was beginning to unravel, the proposal was ***never*** implemented.[105]

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[102] *See* Ambac Amended Complaint ¶ 123 (citing email from John Mongelluzzo (Bear, Stearns & Co. Vice President, 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), dated April 26, 2005, EMC-AMB 001597507-508 (proposing "New Due Diligence Processes," including "[i]dentify higher risk loans within sample to DD firms so that more seasoned UW's are reviewing the loans."); 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 Finance), 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.")).

[103] Ambac Amended Complaint ¶ 123 (citing 6/4/2010 Silverstein Deposition Tr. at 178; 4/21/2010 Mongelluzzo Deposition Tr. at 172).

[104] Assured Complaint ¶ 191 (citing 9/8/2011 Mongelluzzo Deposition Tr. at 160-64; 4/21/2010 Mongelluzzo Deposition Tr. at 175).

[105] Assured Complaint ¶ 191 (citing email from John Mongelluzzo (Bear, Stearns & Co. Vice President, 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; 9/8/2011 Mongelluzzo Deposition Tr. at 167-69; 4/21/2010 Mongelluzzo Deposition Tr. at 174-75).

154. Reflecting 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 made as early as May 2005 "to track loans that are overridden by our due diligence managers and track the performance of those loans."[106] 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[, to] determine how different credit performance is for loans that had been flagged as 'exceptions' vs. those that were not."[107] But that is what Haggerty and others at Bear Stearns desperately wanted to avoid. Bear Stearns did not want to track or document the particular reasons for its overrides and the "exceptions" it made to underwriting guidelines to allow defective loans to be purchased.

155. Bear Stearns thus did not implement Mongelluzzo's proposal; instead, it did the opposite by maintaining a policy of directing its due-diligence firms to "purg[e] all of the older reports on the trade leaving only the final reports."[108] A Bear Stearns due-diligence manager has confirmed that, pursuant to this policy, she did not retain the "daily reports" submitted by the

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[106] Ambac Amended Complaint ¶ 129 (citing email from John Mongelluzzo (Bear, Stearns & Co. Vice President, 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), dated May 11, 2005, EMC-AMB 001597504).

[107] Ambac Amended Complaint ¶ 129 (citing email from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head, Mortgage Finance), dated April 25, 2005, EMC-AMB 001699079-080).

[108] *See* Assured Complaint ¶ 193 (citing 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 EMC-AMB 004416524 (attaching the EMC Conduit Manual, Bulk Underwriting Chapter, dated April 30, 2005 and March 1, 2006). *See also* EMC Conduit Manual, Bulk Underwriting Chapter, dated Sept. 30, 2003, EMC-ASSURED 000818571-590, at EMC-ASSURED 000818581-82 (providing that only the final Due Diligence Summary is shared with distribution list)).

due-diligence firms.[109] By company policy, therefore, Bear Stearns destroyed evidence of the audit trails concerning the high incidence of Bear Stearns's overrides and waivers leading up to its final purchase decisions.[110] As a former Watterson Prime consultant that conducted due diligence on Bear Stearns loans has confirmed, "the vast majority of the time the loans that were rejected were still put in the pool and sold."[111]

3. Bear Stearns Covertly Implemented Policies to Securitize Defective Loans

156. Armed with the knowledge that its due-diligence protocols were patently inadequate or simply ignored, Bear Stearns's trading desk devised policies to rid its inventory of the toxic loans that 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 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. 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 was acquired from the originator.

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[109] *See* Assured Complaint ¶ 193 (citing 5/28/2010 Sears Deposition Tr. at 101-03).

[110] Assured Complaint ¶ 193 (citing 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 EMC-AMB 004416524 (attaching the EMC Conduit Manual, Bulk Underwriting Chapter, dated April 30, 2005 and March 1, 2006)).

[111] Assured Complaint ¶ 193 (citing 8/25/2010 Warren Deposition Tr. at 51; 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; 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 Watterson Prime employee's public admissions)).

157. Bear Stearns's prior policy was to keep loans in its inventory and "not securitize those loans until the early payment default period ran."[112] Because, as discussed above, Bear Stearns 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 securitization of loans likely to "contain some form of misrepresentations and [that] should not have been made."[113] As revealed in Assured's lawsuit against Bear Stearns, 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.[114] The former head of Bear Stearns's 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]."[115]

158. Bear Stearns covertly began securitizing loans before the EPD period ran during 2005,[116] and by the end of 2005 – months before the first of the Transactions closed – the Bear Stearns trading desk made that practice the rule. On or about December 2005, Verschleiser

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[112] Ambac Amended Complaint ¶ 140 (citing 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 . . . ");*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.")).

[113] Ambac Amended Complaint ¶ 140 (citing 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.")).

[114] Ambac Amended Complaint ¶ 140 (citing 6/4/2007 Silverstein Deposition Tr. at 192; and noting that 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)).

[115] Ambac Amended Complaint ¶ 140 (citing 4/15/2007 Gray Deposition Tr. at 113-14).

[116] Ambac Amended Complaint ¶ 141 (citing 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.")).

ordered Bear Stearns's deal managers and traders to start securitizing all "the subprime loans closed in December for the conduit" by January 2006. 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."[117]

159. 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***."[118] 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."[119]

160. While recognizing fully that its revised policy materially increased the risk profile 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."[120]

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[117] Ambac Amended Complaint ¶ 141 (citing 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).

[118] Ambac Amended Complaint ¶ 142 (citing 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).

[119] Ambac Amended Complaint ¶ 142 (citing 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).

[120] *See* Ambac Amended Complaint ¶ 143 (citing, *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 [a] party external to the firm.")).

161. Because large volumes of securitized loans were beginning to experience delinquencies within the EPD period, and because, as noted, Bear Stearns had contractual recourse against the originators of such loans, Bear Stearns issued repurchase claims against the originators despite having already securitized the loans. 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. Bear Stearns did not require these entities to repurchase a loan that it had already sold – that necessarily would have required Bear Stearns to itself repurchase the loan from the securitization trust. Bear Stearns instead would "provide alternatives to repurchase of a loan, such as a price adjustment."[121] As discussed below, Bear Stearns presented other alternatives permitting its recovery for EPD claims while accommodating its suppliers. These alternatives included cash settlements for a fraction of the repurchase price, "downbids," or other credits for future loan purchases.

162. For example, 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."[122] The Managing Director that oversaw the preparation of the presentation also admitted that "EPDs were the majority . . . of the

[121] *See* Ambac Amended Complaint ¶ 144 (citing, *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.")).

[122] Ambac Amended Complaint ¶ 146 (citing "EPD Summary" Report, EMC-AMB 004099954; 4/26/2010 Golden Deposition Tr. at 255-56).

volumes of claims that EMC Mortgage Corporation submitted against sellers in 2005 and 2006," and pertained to loans that were in Bear Stearns's securitizations.[123] 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."[124]

163. 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."[125] To the contrary, to perpetuate these recoveries and conceal loans that it knew raised "red flags" of fraud and other defects, the manager of Bear Stearns's 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, including Ambac, to assess whether there might be other breaches of reps and warranties other than an EPD breach."[126]

164. 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.

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[123] Ambac Amended Complaint ¶ 146 (citing 4/26/2010 Golden Deposition Tr. at 120-21).

[124] Ambac Amended Complaint ¶ 146 (citing 4/26/2010 Golden Deposition Tr. at 141).

[125] Ambac Amended Complaint ¶ 148 (citing 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.")).

[126] Ambac Amended Complaint ¶ 148 (citing 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 94-95; 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")).

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

165. As discussed above, Bear Stearns represented to Ambac, rating agencies and potential investors that the securitization participants would benefit from Bear Stearns's "quality control" operations, which re-underwrote loans "post settlement" or ***after*** Bear Stearns had purchased and securitized those loans.[127] Bear Stearns's 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.[128] Bear Stearns reviewed "sample queries of production [to] determine if . . . the underwriter was doing their [sic] job and if it was underwritten correctly or there was any defect in the loan."[129] 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").[130]

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[127] *See* Ambac Amended Complaint ¶ 150 (citing 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."); 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")).

[128] Ambac Amended Complaint ¶ 150 (citing 4/26/2010 Golden Deposition Tr. at 208-209).

[129] Ambac Amended Complaint ¶ 150 (citing 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 127; and noting that 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." 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")).

[130] Ambac Amended Complaint ¶ 150 (citing 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

166. Bear Stearns's commitments to review, identify, and flush out defective loans found after securitization were material to Ambac's participation in the Transactions. 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, and ultimately financial guarantors such as Ambac, that were left with the massive risks and losses on the loans. That is, when a securitized loan defaulted during the EPD period or Bear Stearns identified a breach of a representation and warranty 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 ("securitization breaches") 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.[131]

167. Reflecting its decision ***not*** to review defective loans for securitization breaches, Bear Stearns's 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

breach. . . it was actually the individual who reviewed the loan did the original QC."); 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")).

[131] As Mary Haggerty confirmed in her deposition in connection with Ambac's first lawsuit against Bear Stearns, 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 the seller if there was a breach of the a rep and warranty." No securitization-breach review was commenced at that time. *See* Ambac Amended Complaint ¶ 151 (citing 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 464, 476-77).

conduit" (which was the source of the vast majority of loans at issue in this action).[132] 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."[133] In other words, Bear Stearns simply ignored EMC's express representations, warranties, and covenants, set forth below, requiring prompt disclosure of breaching loans irrespective of Bear Stearns's claims against the sellers of those loans.

168. Consequently, despite the substantial number of EPD claims Bear Stearns asserted against the suppliers of the securitized loans, its quality-control operations generally did not review those loans for securitization breaches. In a document brought to light in Ambac's first action against Bear Stearns in this Court, a Bear Stearns quality-control manager revealed Bear Stearns's reasoning for avoiding securitization-breach reviews: "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?"[134] (The "PSA" is, along with the MLPA, one of the documents in which EMC ***made*** representations and warranties to the securitizations and agreed to repurchase loans that breached those representations and warranties.) 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.

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[132] Ambac Amended Complaint ¶ 152 (citing 5/20/2010 Serrano Deposition Tr. at 47; *id.* at 44 (noting that as of September 2006, Bear Stearns's securitization breach review "was not something that was executed correctly")).

[133] Ambac Amended Complaint ¶ 152 (citing EMC-AMB 010726678; and noting that the policies in place as of January 2007 for "reviewing loans for breaches," also provide that "[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).

[134] Ambac Amended Complaint ¶ 153 (citing 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).

169. The percentage of defective loans Bear Stearns identified through its quality-control sampling review was substantial. As revealed in Ambac's first action, Bear Stearns contracted with Adfitech, Inc. ("Adfitech") to perform the quality-control reviews on its behalf, 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."[135] With this as its directive, Adfitech conducted quality-control review of samples of loans Bear Stearns acquired. For the period through the end of 2006, Adfitech found that a significant number of loans were defective based on Bear Stearns's quality-control guidelines. Although these findings revealed material information about the risk profile of the loans – as well as breaches of EMC's representations and warranties (discussed below)[136] – at no time did Bear Stearns disclose these remarkably high defect rates to Ambac or other securitization counterparties.

170. 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

[135] Ambac Amended Complaint ¶ 154 (citing Contractor Services Agreement between EMC and Adfitech, dated January 26, 2005, EMC-AMB 000229896-918 at 909; and noting that 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 Mortgage Corp., Quality Control Manager), dated February 2, 2007, EMC-AMB 006975253-267 at 255, 261).

[136] Ambac Amended Complaint ¶ 154 (citing 4/26/2010 Golden Deposition Tr. at 104-105; and noting that, in effectively conceding that the Adfitech quality-control findings evidenced securitization breaches, Bear Stearns's Senior Managing Director of the quality-control department confirmed that between 2005 through 2006 it applied the same criteria for both its quality-control and securitization-breach analyses).

against the loan suppliers on the basis that the loans were "not eligible for delivery to EMC" – without disclosing that it already had sold the loans into a securitization.[137]

171. By concealing the true nature of its quality-control operations, Bear Stearns deceived securitization participants, including Ambac

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

172. By at least 2006, Bear Stearns had acquired and securitized so many defective and toxic loans that its quality-control and claims departments became overwhelmed to the point that Bear Stearns was unable to process its claims against the entities from which it purchased the loans. 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's "rapid increase in the amount of loans being purchased and securitized." [138]

173. A recently revealed internal audit report issued on February 28, 2006 and distributed to senior executives including Haggerty, Cayne, Marano, Mayer, Schwartz, and Spector[139] also confirms Bear Stearns's 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 $720 million, and concluding that the procedures in place to process, collect, resolve, and monitor such claims were inadequate or simply non-existent.[140]

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[137] *See* Ambac Amended Complaint ¶ 155.

[138] Ambac Amended Complaint ¶ 158 (citing 4/26/2010 Golden Deposition Tr. at 119-20).

[139] Ambac Amended Complaint ¶ 159 (citing email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department) dated March 7, 2006, EMC-AMB 001496304).

[140] Ambac Amended Complaint ¶ 159 (citing EMC-AMB 001496305-EMC-AMB 001496311, "Bear Stearns Internal Audit Report – EMC Mortgage Corporation ('EMC') – Review of Representations and Warrants Department.")

174. 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."[141] Indeed, also recently revealed 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.[142]

175. No one at Bear Stearns disclosed to Ambac that it had acquired and securitized so many defective loans, requiring claims against originators so numerous that its internal departments could not handle the workload. The defective loans that Bear Stearns's understaffed departments were able to identify and file claims for represent just a small fraction of the total defective loans that were securitized to the detriment of investors and Ambac.

6. Bear Stearns Failed to Disclose that Its Counsel and Outside Auditors Found that Its Claims Practices Contravened Its Contractual Obligations, Investors' Expectations, and Industry Standards

176. By mid-2006, the growing backlog of Bear Stearns's 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.

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[141] Ambac Amended Complaint ¶ 160 (citing emails from Mary Haggerty (Bear, Stearns & Co. Senior Managing Directors, Co-Head Mortgage Finance) 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).

[142] Ambac Amended Complaint ¶ 160 (citing 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").

177. In August 2006, Bear Stearns's 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. 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." 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." 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.[143]

178. Shortly thereafter, Bear Stearns's legal counsel reinforced PWC's assessment and advised Bear Stearns that it had to revise its improper practices. Haggerty confirmed that, in 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.[144]

179. 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) was improperly retaining recoveries on those loans that

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[143] *See* Ambac Amended Complaint ¶ 163 (citing EMC-AMB 006803201-277, "UPB Break Repurchase Project – August 31, 2006").

[144] Ambac Amended Complaint ¶ 164 (citing 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. 455-63, 510).

should have been passed on to the securitizations.[145] 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!"[146] 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.[147] Bear Stearns concealed these operational deficiencies from Ambac and other securitization participants.

180. Contrary to its own counsel's advice, Bear Stearns did not implement a policy to promptly review defective or defaulted loans for securitization breaches until at least September 2007, long after the closing of the Transactions and only after the defaults on its securities began to rise sharply.[148] According to its employees who have testified in Ambac's first action, 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.[149]

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[145] Ambac Amended Complaint ¶ 165 (citing 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. 510; 4/19/2010 Glory Deposition Tr. 125).

[146] Ambac Amended Complaint ¶ 165 (citing 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).

[147] Ambac Amended Complaint ¶ 165 (citing 1/7/2010 Mesuk Rule 30(b)(6) Deposition Tr. at 115-18).

[148] *See* Ambac Amended Complaint ¶ 166 (citing email 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).

[149] Ambac Amended Complaint ¶ 166 (citing 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); 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

181. 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. 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.

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

182. 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. These concessions were designed to keep Bear Stearns's suppliers happy and ensure the continued flow of loans from these entities for Bear Stearns to package and bundle into future securitizations. 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 past securitizations.

183. 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 has 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 trusts.[150] Indeed, had it done so, Bear Stearns would have alerted the securitization participants to the

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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)).

[150] Ambac Amended Complaint ¶ 169 (citing 4/26/2010 Golden Deposition Tr. at 148).

steadily growing number of loans plagued by material underwriting failures and other fraudulent activities.

184. Accordingly, through EMC, Bear Stearns entered into confidential settlement agreements with loan suppliers to resolve EPD and other claims in exchange for cash payments at a fraction of the repurchase price – all ***in lieu of repurchasing the defective loans***. In other instances, Bear Stearns accommodated originators by agreeing to (i) cancel or waive the claims entirely,[151] or (ii) create "reserve programs" that allowed it to use funds obtained from these entities for EPD violations and other defects by applying them toward future loan purchases.[152] Each of these alternatives provided additional consideration to Bear Stearns for toxic loans that it had already sold to and that remained in securitizations, while at the same time keeping its suppliers happy so as to maintain loan production for inclusion in subsequent securitizations.

185. The limited documentation secured to date by Ambac in Ambac's existing action against Bear Stearns in this Court reveals that Bear Stearns 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 that Bear Stearns put back to

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[151] *See* Ambac Amended Complaint ¶ 170 (citing emails from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), 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"); 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")).

[152] *See* Ambac Amended Complaint ¶ 170 (citing 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 . . . ."); 12/11/2009 Durden Rule 30(b)(6) 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.")).

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 of the total value of the repurchase claims.[153]

186. 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's securitizations. Bear Stearns generated billions of dollars in recoveries through these activities. As brought to light in Ambac's first action, Bear Stearns's 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."[154]

187. 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.[155] And, by concealing the large volumes of defective loans and keeping for itself the recoveries generated from its undisclosed settlements with originators, Bear Stearns had no economic

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[153] Ambac Amended Complaint ¶ 171.

[154] Ambac Amended Complaint ¶ 174 (citing Bear Stearns Internal Audit Department Escalation Memorandum entitled "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).

[155] *See* Ambac Amended Complaint ¶ 175 (citing 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")).

incentive to honor its obligations to its securitizations because it then would have had 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 the sellers."[156] By making these enormous financial concessions, Bear Stearns continued to foster and financially reward the same type of abysmal origination practices by its sellers that had resulted in these defective loans in the first place. And, best of all, these practices allowed Bear Stearns to continue to keep securitization participants in the dark about the quality of the loans it was packaging into its transactions.

C. BEAR STEARNS MADE MATERIAL MISREPRESENTATIONS AND OMITTED MATERIAL FACTS CONCERNING THE QUALITY AND ATTRIBUTES OF THE LOANS IT PACKAGED INTO THE TRANSACTIONS

188. In addition to making material misrepresentations and omissions regarding the protocols in place to ensure the quality of securitized loan pools, Bear Stearns knowingly made material misrepresentations and omissions regarding the particular loans it included in the Transactions.

189. The results of Ambac's recent loan-level forensic analyses – as well as the abysmal performance of the Transactions – confirm that Bear Stearns's fraudulent practices described above materially affected the credit quality of the loans included in the Transactions at issue in this litigation.

[156] Ambac Amended Complaint ¶ 175 (citing 4/26/2010 Golden Deposition Tr. at 63-65 (explaining Bear Stearns's Risk Management Division Report, EMC-AMB 010775342-407)).

190. Bear Stearns knowingly, and with intent to defraud, provided Ambac false and misleading loan-level data relating to the loans in advance of closing of the Transactions. As set forth earlier, Bear Stearns sent Ambac in advance of closing numerous preliminary and final loan tapes for each Transaction setting forth key metrics for assessing the borrowers' ability to repay their loans, their intentions to occupy the mortgaged properties, and the sufficiency of those properties as collateral. Bear Stearns knew that Ambac would rely, and intended that Ambac rely, on the veracity of the loan tapes to evaluate the Transactions and assess the "market risks" pertaining to the loans.[157]

191. As noted above, in the Offering Documents, Bear Stearns represented that the loans securitized in the Transactions were originated in accordance with the underwriting criteria described in the Offering Documents. In addition, the Offering Documents presented data metrics that Bear Stearns represented accurately reflected the attributes of the securitized loans, as well as credit ratings that Bear Stearns secured for the Transactions based on information it provided to the rating agencies.

192. A loan-level review recently undertaken by Ambac has revealed that the information provided by Bear Stearns to Ambac on the loan tapes prior to the closing of the Transactions, and that was reflected in the Offering Documents, was materially false and misleading. A forensic review of more than 5,000 loans included in the Transactions revealed that, on average, nearly 15%[158] of the loans sampled that the tapes showed as being "owner occupied" have strong indications that they were actually investor properties or second homes,

[157] Ambac Amended Complaint ¶ 92 (citing 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).

[158] This conclusion is arrived at by dividing (a) the number of properties in the samples that were reported as owner-occupied but show strong indications that their owners lived elsewhere (here, 555) by (b) the number of properties in the samples that were reported as being owner-occupied on the data tapes for the relevant Transactions (here, 3,763).

which have a higher risk of default, and more than 23% of the loans sampled had LTV ratios 10% or more higher than Bear Stearns represented on the tapes. Indeed, more than 8% of the loans sampled had LTV ratios greater than 100%, meaning that the size of the loan was already greater than the value of the property ***at origination***. Therefore, the loans were of much poorer credit quality and much more likely to default than Ambac reasonably expected based on Bear Stearns's representations and disclosures. These differences are significant as they fundamentally altered the represented characteristics of the collateral in the Transactions, which Ambac relied upon in deciding whether to issue its Policies.

193. From nine of the loan "groups" that serve as collateral for the Insured Certificates in the Transactions, Ambac's third-party forensic consultant selected loans to review to determine whether Bear Stearns's representations regarding (1) owner-occupancy rates and (2) LTV ratios were accurate. For those loan groups with more than 1,000 loans, Ambac reviewed 500 randomly selected loans. For those loan groups with fewer than 1,000 loans, Ambac reviewed every loan in the group for which information was available. In total, Ambac reviewed over 5,000 loans underlying the Insured Certificates. Ambac's sample sizes are more than sufficient to provide statistically significant data to demonstrate the degree to which Bear Stearns misrepresented certain of the material characteristics of the loans.

194. Ambac's findings – understated percentages of owner-occupied properties and inflated appraisals (leading to undervalued LTV ratios) – were well known to Bear Stearns at the time of the Transactions. As noted above, when asked what the most common loan defects were from 2003 to 2007, Haggerty told the FCIC, "I think what one would typically see would be things like the appraised value of the property was misstated. It could be that the borrower represented that they were going to be the primary residence, and it was in fact an investor

property, it was discovered."[159] What Bear Stearns knew then, Ambac – through its consultants' reviews – knows only now.

1. Contrary to Bear Stearns's Representations, There Are Numerous Indications that Borrowers Did Not Actually Occupy the Mortgaged Properties

195. To determine whether a given borrower actually occupied the property as claimed, Ambac's consultants investigated tax information for the sampled loans. One would expect a borrower residing at a property to have tax bills sent to that address and to take all applicable tax exemptions available to residents of that property. If a borrower had his or her tax records sent to another address, that is good evidence that the borrower was not actually residing at the mortgaged property. If a borrower declined to make certain tax-exemption elections that depend on the borrower living at the property, that, too, is strong evidence that the borrower was living elsewhere.

196. Ambac's consultants also reviewed credit records. One would expect that people have bills sent to their primary address. If a borrower tells creditors to send bills to another address, even six months after buying the property, that is good evidence that the borrower was living elsewhere.

197. Ambac's consultants also reviewed property records. If a borrower owns multiple properties, his or her likelihood of living in any one property is diminished. If a concurrently owned separate property did not have its own tax bills sent to the property listed on the data tape for the Transaction, the borrower's likelihood of living in the mortgaged property is even slimmer.

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[159] February 24, 2011 FCIC Interview with former Bear Stearns Senior Managing Director Mary Haggerty, Tr. at 32.

198. Ambac's consultants also reviewed other lien records. If the mortgaged property was subject to additional liens but the materials related to those liens were sent elsewhere, that is good evidence that the borrower was not living at the mortgaged property. If the other lien involved a conflicting declaration of residency, that, too, would be good evidence that the borrower did not live in the mortgaged property.

199. The below table sets forth the results of Ambac's loan-level analysis of true owner-occupancy rates of loans in its samples. Failing more than one of the above tests is strong evidence that the borrower did not in fact reside at the mortgaged property. These statistics therefore demonstrate that, contrary to the information Bear Stearns represented to Ambac in the loan tapes, a much higher percentage of borrowers did not occupy the mortgaged properties.

Transaction	Supporting Loan Group	Percentage of Non-Owner Occupied Properties Reported on Tape[160]	Percentage of Properties Reported as Owner-Occupied with Strong Indication of Non-Owner Occupancy	Actual Percentage of Non-Owner-Occupied Properties	Percentage of Understatement of Non-Owner-Occupied Properties
GPMF 2006-AR2	Group I	57.2%	19.8%	65.7%	8.5%
GPMF 2006-AR2	Group II	44.3%	11.3%	50.6%	6.3%
GPMF 2006-AR3	Group II	49.8%	21.5%	60.6%	10.8%
SAMI 2006-AR7	Not Applicable	22.0%	16.4%	34.8%	12.8%
SAMI 2006-AR8	Not Applicable	18.4%	16.9%	32.2%	13.8%
BSMF 2006-AR2	Group II	5.6%	11.0%	16.0%	10.4%
BSMF 2006-AR4	Not Applicable	7.1%	12.2%	18.5%	11.4%
BALTA 2006-R1	Group II-2	14.6%	15.0%	27.4%	12.8%
BALTA 2006-R1	Group II-3	20.2%	12.8%	30.4%	10.2%

2. The LTV Ratios on the Data Tapes Were Based on Incorrect Appraisals and Therefore Were Severely Understated

200. For each of the sampled loans, the underlying property was retroactively valued by an industry-standard automated valuation model ("AVM"). AVMs are routinely used in the

[160] This percentage covers properties that were reported as either investor properties or second homes.

industry as a way of valuing properties during prequalification, origination, portfolio review, and servicing. AVMs have become ubiquitous enough that their testing and use is specifically outlined in regulatory guidance and discussed in the Dodd-Frank Act. AVMs rely upon data that is similar to what appraisers rely on – primarily, county-assessor records, tax rolls, and data on comparable properties. AVMs produce independent, statistically derived valuation estimates by applying modeling techniques to this data. The AVM that Ambac's consultants used incorporates a database that covers 98% of all U.S. ZIP codes, representing 99% of the U.S. population, 97% of all properties, more than 50 million active mortgages, and 96% of loan-level, nonagency mortgage-backed securities. Independent testing services have determined that this AVM is the most accurate of all such models.

201. Applying the AVM to the available data for the loans sampled from the Transactions reveals that the appraised value of the mortgaged properties at origination was significantly higher than what the properties were actually worth at the time of the appraisal. Using this re-appraised value affected the LTV ratios by decreasing the actual value of the properties relative to the loan amount, thereby increasing the overall ratio. Overall, more than 23% of the loans had recalculated LTV ratios of at least 10% higher than what was represented on the data tapes, and more than 15% of the loans had recalculated LTV ratios of at least 15% higher than what was represented on the data tapes. This overvaluation affected numerous statistics set forth on the data tapes and/or in the Offering Documents.

202. For instance, Bear Stearns misrepresented the number of loans with LTV ratios greater than 90%. LTV ratios in excess of 90% provide the lender little equity cushion to protect against borrower default and loss upon foreclosure. However, the AVM results indicate that a

much higher percentage of loans had LTV ratios higher than 90%. The LTV ratios were understated by Bear Stearns, as shown in the chart below:

Transaction	Supporting Loan Group	Percentage of Loans with an LTV Greater than 90% as Represented on the Tape	Actual Percentage of Loans with an LTV Greater than 90%	Percentage of Understatement
GPMF 2006-AR2	Group I	0.0%	21.3%	21.3%
GPMF 2006-AR2	Group II	0.2%	22.2%	20.0%
GPMF 2006-AR3	Group II	0.4%	19.2%	18.8%
SAMI 2006-AR7	Not Applicable	3.6%	27.8%	24.2%
SAMI 2006-AR8	Not Applicable	2.0%	28%	26.0%
BSMF 2006-AR2	Group II	0.0%	21.0%	21.0%
BSMF 2006-AR4	Not Applicable	0.0%	24.9%	24.9%
BALTA 2006-R1	Group II-2	0.2%	14.6%	14.4%
BALTA 2006-R1	Group II-3	0.2%	21.8%	21.6%

203. Further, the data tapes uniformly show that none of the loans that collateralized an Insured Certificate had LTV ratios greater than 100%, meaning the size of the loan was represented as ***never*** being greater than the value of the property. (This is known as being "underwater" – *i.e.*, when a borrower owes more on the property than it is worth.) Loans with LTV ratios of more than 100% afford the lender no equity cushion and leave the lender with inadequate collateral from the outset of the loan. As a result, the borrower has less incentive to repay his or her loan. Ambac's analysis has found that, despite Bear Stearns's representations to the contrary, a substantial number of loans had true LTV ratios greater than 100%, as follows:

Transaction	Supporting Loan Group	Percentage of Loans with an LTV Greater than 100% as Represented on the Tape	Actual Percentage of Loans with an LTV Greater than 100%	Percentage of Understatement
GPMF 2006-AR2	Group I	0	8.3%	8.3%
GPMF 2006-AR2	Group II	0	9.4%	9.4%
GPMF 2006-AR3	Group II	0	5.6%	5.6%
SAMI 2006-AR7	Not Applicable	0	11.6%	11.6%
SAMI 2006-AR8	Not Applicable	0	11.2%	11.2%
BSMF 2006-AR2	Group II	0	5.4%	5.4%
BSMF 2006-AR4	Not Applicable	0	10.4%	10.4%
BALTA 2006-R1	Group II-2	0	5.4%	5.4%
BALTA 2006-R1	Group II-3	0	6.4%	6.4%

204. In addition to understating the LTV ratios on the loan tapes, Bear Stearns also understated the LTV ratios in the Offering Documents. As shown in the chart below, the weighted-average LTV ratios that Bear Stearns provided on the loan tapes and in the ProSupps for the Transactions were significantly lower than the actual weighted-average LTV ratios for the loans in the Transactions.

Transaction	Supporting Loan Group	Weighted Average LTVs as Stated in the ProSupp	Weighted Average LTVs for Samples Represented on the Tape	Actual Weighted Average LTVs for Samples
GPMF 2006-AR2	Group I	77.81	77.61	87.19
GPMF 2006-AR2	Group II	77.86	77.7	88.29
GPMF 2006-AR3	Group II	77.56	76.95	84.62
SAMI 2006-AR7	Not Applicable	75.68	75.1	89.14
SAMI 2006-AR8	Not Applicable	76.43	76.16	88.91
BSMF 2006-AR2	Group II	78.23	77.91	85.3
BSMF 2006-AR4	Not Applicable	77.44	77.33	87.51
BALTA 2006-R1	Group II-2	76.85	78.1	83.61
BALTA 2006-R1	Group II-3	75.02	76.69	86.83

205. These discrepancies with respect to represented LTV ratios indicate that the representations in the Offering Documents relating to the originators' appraisal practices were false, and that the appraisers often provided appraisals that they understood were inaccurate and

that they knew bore no reasonable relationship to the actual value of the mortgaged properties. Independent appraisers following proper practices – as noted, Bear Stearns made representations in the Offering Documents as to the independence of the originators' appraisal practices – would not systematically generate appraisals that deviate so significantly (and so consistently upward) from the true values of the mortgaged properties.

3. Many of Bear Stearns's Representations Regarding Other Aspects of the Loans Were Also False and Misleading

206. In addition to the foregoing analysis, Ambac has sought to evaluate the compliance of individual loans with Bear Stearns's representations about other loan characteristics and underwriting guidelines generally. But Ambac's efforts to obtain the loan files necessary to conduct this more expansive review have been stymied by JP Morgan.

207. First Bear Stearns, and later JPMC Bank, as EMC's successor, have persistently thwarted Ambac's attempts to obtain the loan files necessary for Ambac to fully analyze the loans in the Transactions. As far back as 2009, Ambac demanded access to loan files and underwriting guidelines in the exclusive possession of Bear Stearns. Bear Stearns denied Ambac access by imposing inappropriate and unworkable restrictions on Ambac's use of the information as a precondition to providing such access. Thwarted by Bear Stearns, Ambac sought to obtain access via the trustees administering the trusts for the Transactions.

208. Specifically, in July and August of 2011, Ambac sent several letters to the trustees for the Transactions, requesting that the trustees exercise their powers to safeguard Ambac's and the investors' interests and to help Ambac determine whether the loans complied with Bear Stearns's representations. JPMC Bank, as successor servicer to EMC, has only recently provided the requested information.

209. To date, Ambac's consultant has reviewed 50 loans from each of the GPMF 2006-AR3 and BSMF 2006-AR2 Transactions and found breaches of representations and warranties in 45 of the loans from GPMF 2006-AR3 and 40 of the loans from BSMF 2006-AR2—breach rates of 90% and 80%, respectively. The aggregate original principal balance on just these 85 loans is more than $43.6 million. On April 9, 2012, Ambac provided notice of the breaches and detailed descriptions of the breaches attributable to each loan to all parties with respect to the 85 breaching loans.

210. Examples of defects identified by Ambac's consultants include:

- rampant fraud, primarily involving misrepresentation of the borrower's income, liabilities, employment, or intent to occupy the property as the borrower's primary residence;
- inadequately supported property values; and
- pervasive violations of the applicable underwriting guidelines and prudent mortgage-lending practices, including loans made to borrowers (i) who made unreasonable claims as to their income or otherwise clearly had no ability to repay their loans, (ii) with credit scores below the required minimum, (iii) with LTV ratios above the allowed maximum, or (iv) with relationships to the lender or originator or other non-arm's-length relationships.

These defects materially increased the risk profile of the breaching loans and of the pools of loans included in the Transactions as a whole.

211. All of these findings confirm that the abandonment of underwriting guidelines and the misrepresentation of key loan characteristics were systematic and affected a large percentage of the loans included in the Transactions. In sum, the loans included in the Transactions bore no resemblance to their represented characteristics.

D. BEAR STEARNS'S INDIVIDUAL AND CORPORATE HEDGING STRATEGY DEMONSTRATES ITS KNOWLEDGE OF THE DEFICIENCIES IN THE COLLATERAL BACKING ITS SECURITIZATIONS

212. Bear Stearns's insatiable greed has provided arguably the most damning evidence of Bear Stearns's knowledge of its fraudulent scheme. Not content with the fact that it had made enormous profits by inducing parties like Ambac to participate in RMBS transactions, including the Transactions, that were destined to fail, Bear Stearns devised a scheme to make money on the inevitable demise of the deals it structured. It bet against them.

213. As revealed in Ambac's first action and Assured's recent complaint filed against Bear Stearns in this Court, in late 2007, Bear Stearns implemented a strategy of shorting financial-guaranty insurers, including Ambac, that had insured Bear Stearns securitizations. At the same time, Bear Stearns's Head of MBS, Tom Marano, liquidated his personal exposure to various financial guaranty insurers. These strategies amounted to a contemporaneous recognition and acknowledgement by Bear Stearns, based on inside knowledge, of the poor-quality collateral backing its securitizations, and constitute a bad-faith attempt to profit from its own misconduct.

214. Knowing that Bear Stearns's fraudulent conduct was resulting and would continue to result in grave harm to insurers, in October 2007 Bear, Stearns & Co. Senior Managing Director Jeffrey Verschleiser recommended to Bear Stearns's risk committee that "we should be short a multiple of 10 of the shorts I had put on," because "a few ***financial guarantors were vulnerable*** to potential write downs in the CDO and MBS market."[161] Bear Stearns in fact

[161] Ambac Amended Complaint ¶ 194 (citing email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk, Bear, Stearns & Co.), dated Nov. 20, 2007, EMC-AMB 009600760-763).

executed those trades and "in less than three weeks . . . made approximately $55 million on just these two trades."[162]

215. Contemporaneous with Bear Stearns's corporate short trades, Marano directed his personal financial advisor on November 6, 2007 to assess his exposure to various financial-guaranty insurers and exit those positions.[163] The advisor in fact executed those trades, informing Marano "we will have you ***all out*** by next Monday."[164]

216. Bolstered by the success of its shorting scheme, Bear Stearns continued its trading strategy into 2008, continuing to short both financial-guaranty insurers and the banks with large exposure to the securities they insured. On February 17, 2008, a Bear Stearns trader told colleagues and Verschleiser, "***I am positive fgic is done and ambac is not far behind***."[165] The next day, in the same email chain, the trader again wrote to Verschleiser and others to clarify which banks had large exposures to certain financial guarantors, asking "***who else has big fgic or abk [Ambac] exposures besides soc gen?***"[166] A colleague replied: "I believe the five with the biggest exposures are Barclays, CIBC, Merrill, Soc Gen and UBS. I think ABN, BNP, DB, HSBC and RBS have less."[167] Bear Stearns in fact entered into short positions with respect to

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[162] *Id.*

[163] Assured Complaint ¶ 228 (citing email from Thomas Marano (Bear, Stearns & Co. Senior Managing Director, Head of MBS, ABS, and CMBS), dated Nov. 6, 2007, EMC-AMB 012124275).

[164] Assured Complaint ¶ 228 (citing email from Kenneth Ramos (Bear, Stearns & Co. Managing Director, Private Client Services) to Thomas Marano (Bear, Stearns & Co. Senior Managing Director, Head of MBS, ABS, and CMBS), dated Nov. 6, 2007, EMC-AMB 012124275 (emphasis in original)).

[165] Assured Complaint ¶ 229 (citing email from Adam Siegel (Bear, Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), dated Feb. 17, 2008, EMC-AMB 012117052-063).

[166] Assured Complaint ¶ 229 (citing email from Adam Siegel (Bear, Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading) to Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), among others, dated Feb. 18, 2008, EMC-AMB 012117048-051).

[167] Assured Complaint ¶ 229 (citing email from Warren Saft (Bear, Stearns & Co. trader), to Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk, Bear, Stearns & Co.), among others, dated Feb. 18, 2008, EMC-AMB 012117048-051).

those banks based on the knowledge of the banks' exposure to financial-guaranty-insured RMBS transactions.[168] At the same time, Bear Stearns entered into single-name corporate credit-default swaps shorting Ambac and other insurers to hedge Bear Stearns's retained positions in its insured securitizations.[169]

217. As it was shorting financial-guaranty insurers and the banks holding the Bear Stearns securities they insured, Bear Stearns continued to conceal the defects related to the collateral backing the securities issued in connection with the Transactions.

VII. AMBAC'S RELIANCE ON BEAR STEARNS'S REPRESENTATIONS WAS JUSTIFIABLE AND ITS DUE DILIGENCE WAS REASONABLE AND CONSISTENT WITH THE RISK ALLOCATION IN THE TRANSACTIONS

218. Bear Stearns knowingly and with the intent to induce reliance thereon made the foregoing material misrepresentations to Ambac and investors and actively concealed material information pertaining to its securitization practices generally and the specific Transactions at issue in this litigation. These misrepresentations and omissions fraudulently induced Ambac to insure and investors to purchase the Certificates issued in the Transactions. In addition, Bear Stearns's false and misleading representations and omissions pertaining to each Transaction fraudulently induced Ambac to enter into each subsequent Transaction.

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[168] Assured Complaint ¶ 229 (citing email from Beau Paulk (Bear, Stearns & Co. employee) to Thomas Marano (Bear, Stearns & Co. Senior Managing Director, Head of MBS, ABS and CMBS), Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), and Jeff Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), among others, dated March 17, 2008, EMC-AMB 011189682-83 (attaching "Department Hedge Summary" as of March 14, 2008)).

[169] Assured Complaint ¶ 229 (citing email from Beau Paulk (Bear, Stearns & Co. employee) to Marano (Bear, Stearns & Co. Senior Managing Director, Head of MBS, ABS and CMBS), Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), and Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), among others, dated March 17, 2008, EMC 011189682-83 (attaching "Department Hedge Summary" as of March 14, 2008); email from Thomas Marano (Bear, Stearns & Co. Senior Managing Director, Head of MBS, ABS, and CMBS) to Scott Eichel (Bear, Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), and Adam Siegel (Bear, Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), dated Feb. 20, 2008, EMC-AMB 005486578-580).

219. Ambac reasonably relied to its detriment on Bear Stearns's false and misleading representations and material omissions – contained in, among other things, data tapes, Offering Documents, and investor presentations – concerning (i) its internal operations, including its seller-approval, due-diligence, quality-control, and loan-repurchase protocols, (ii) the mortgage-loan data that Bear Stearns disseminated in electronic "tapes" and the Offering Documents for each Transaction, (iii) the rating agencies' shadow ratings that Bear Stearns secured for each Transaction, (iv) the historical performance of Bear Stearns's securitizations and mortgage loans, (v) the underwriting practices that were followed during the origination of the loans, and (vi) Bear Stearns's wherewithal and intent to stand behind the representations and warranties that EMC made in the agreements governing the Transactions.

220. Ambac's reasonable reliance on Bear Stearns's representations and omissions was contemporaneously documented in both internal Ambac emails and formal memoranda that Ambac prepared to obtain internal approval from its Credit Committee for each of the Transactions (the "Underwriting Reports"). To start, the Underwriting Report for each Transaction underscored the perceived significance of Bear Stearns as a counterparty, listing "Bear Stearns" as the "Investment Banker," one of four key transaction-identifying facts (along with "Report Date," "Ambac Analysts," and "Closing Date") listed at the top of each report. Also among the first items set forth in the Underwriting Reports are the ratings that Bear Stearns secured from the ratings agencies. Reflecting the importance of the ratings to Ambac, the Underwriting Reports often list the ratings as one of several items that need to be "Satisfied" before Ambac decides to participate in the relevant Transaction. Similarly, the Underwriting Reports alternately refer to the ratings as among the "Mitigating Factors" for risks associated with the relevant Transaction and as part of the "Rationale" for approving the Transactions.

221. The Underwriting Reports also make plain how central Bear Stearns's representations regarding, in particular, the loan characteristics (as reflected in the loan tapes and Offering Documents) and the underwriting practices of the various originators (as reflected in the Offering Documents) were to Ambac's decision to insure the Transactions. The Underwriting Reports mention various loan characteristics, often in summary or aggregate form, on almost every page and typically include "Pool Characteristics" with additional loan-level detail as the first of several exhibits. The other exhibits, except for the last, are various models for which the loan characteristics serve as inputs. Almost every Underwriting Report lists several pool-wide loan characteristics – in particular, "WA LTV" (or weighted average loan-to-value ratio) – as among the "Strengths" or "Risk Mitigants" of the relevant Transaction. Conversely, other pool-wide characteristics – in particular, the number of non-owner-occupied properties – are listed as "Weaknesses" or "Risks." Without the loan characteristics provided to Ambac on the data tapes and in the Offering Documents, in short, Ambac would have been unable to model and assess the market risk of loss on the Transactions, precisely the risk that Ambac was agreeing to insure.

222. The final exhibit to each Underwriting Report is typically a detailed description – derived, in some cases verbatim, from the descriptions in the ProSupps that Bear Stearns had provided to Ambac – of the originators' underwriting practices. For example, Exhibit 5A to the Underwriting Report for the BSMF 2006-AR4 Transaction gives a "Servicer and Originator Overview" of EMC and BSRM, respectively. The overview of EMC includes notes from a due-diligence visit that two Ambac employees made to EMC in May 2006. During that visit – which involved "close discussions with EMC's senior management regarding its underwriting guidelines and servicing" – EMC represented to Ambac that "EMC continuously examines methodologies, and exercises financial prudence in every step of the servicing process" and gave

Ambac the impression that EMC had "strong financial condition and the support of its parent [Bear Stearns]."

223. The overview of BSRM, which originated approximately 36% of the loans in the BSMF 2006-AR4 Transaction and 91% of the loans in the BSMF 2006-AR2 Transaction, includes numerous lengthy excerpts from the ProSupp regarding the "BSRM Underwriting Guidelines." The first excerpt is Bear Stearns's statement that "[t]he BSRM Alt-A Underwriting Guidelines are intended to ensure that [i] the loan terms relate to the borrower's willingness and ability to repay and [ii] the value and marketability of the property are acceptable." Other excerpts include descriptions of BSRM's various loan products, including so-called SISA or "Stated Income/Stated Assets" loans. Even for those loans, the excerpt assures, "[t]he applicant's income as stated must be reasonable for the related occupation, borrowers' credit profile and stated asset, in the loan underwriter's discretion." The exhibit also includes an excerpt about BSRM's exceptions policy, whereby exceptions "are considered" but only "with reasonable compensating factors on a case-by-case basis and at the sole discretion of senior management."

224. The Underwriting Report for the GPMF 2005-AR5 Transaction, which predated by only five months and served as the basis for the GPMF 2006-AR2 Transaction, includes similarly detailed descriptions of GreenPoint's underwriting practices (GreenPoint originated all of the loans in not only the GPMF 2005-AR5 Transaction, but also the GPMF 2006-AR2 and GPMF 2006-AR3 Transactions). Again copying Bear Stearns's representations in the ProSupp, the Underwriting Report notes that GreenPoint's limited-documentation loan products, which constituted the overwhelming majority of the loans in the three above-noted deals, "are generally limited to borrowers with credit histories that demonstrate an established ability to repay

indebtedness in a timely fashion."[170] The Underwriting Report also speaks to Ambac's ongoing comfort with Bear Stearns and reliance on its stature in the industry, listing as three of the five items under the heading "Rationale" for approval of the transaction that (1) "The loans . . . will be serviced by an established, experienced market participant [EMC]," (2) "The loans are serviced by a seasoned, financially sound entity – EMC Mortgage Corp," and (3) "The transaction will strengthen our relationship with Bear Stearns, an experienced and seasoned leader in the RMBS market."[171] Two similar reports that Ambac drafted in connection with other Bear Stearns-underwritten and EMC-sponsored transactions that closed during the same time period as the Transactions also reveal Ambac's reliance on Bear Stearns's representations regarding the due diligence it purported to perform in advance of closing: "There is no additional diligence done [by Ambac] at the time of the securitization ***as we rely on the EMC bulk and flow due diligence process***."[172]

225. Lacking an accurate depiction of Bear Stearns's and originators' practices, Ambac's reliance on Bear Stearns's representations was reasonable and consistent with the industry practice and the parties' bargain. As was the general practice and the parties' agreement, Bear Stearns and Ambac assumed risk and undertook due diligence consistent with their respective roles in the Transactions.

226. Bear Stearns, as the sponsor and seller (through EMC), and as the underwriter and deal manager (through Bear, Stearns & Co.), assumed the risk and the burden of assessing the validity of the attributes of the mortgage loans that it conveyed to the securitization trusts,

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[170] GPMF 2005-AR5 Underwriting Report at p. 5.

[171] *Id.* at p. 6.

[172] *See* Ambac's credit memoranda for the SACO 2006-2 and SAC0 2005-10 transactions, both of which Bear, Stearns & Co. also underwrote and marketed and which EMC also sponsored (and Ambac also insured). Those two transactions are at issue in Ambac's first action against Bear Stearns in this Court.

including that the loans were originated pursuant to the appropriate underwriting guidelines and were not fraudulently procured. Ambac as the insurer bore the market risk and the burden of evaluating whether loans ***bearing the attributes represented by Bear, Stearns & Co. and warranted by EMC*** would perform after the closing of the Transactions.

227. That was a reasoned risk allocation. Bear Stearns was in privity with – and often financed – the originators that sold to Bear Stearns the loans that it in turn conveyed to the securitization trusts. Bear Stearns dictated the underwriting guidelines, owned the loans and held the loan files, all of which afforded it access and control over information required to evaluate the loans. To the extent Bear Stearns identified any defect in any loans, it had the right to exclude the loans from any transaction with the entity selling Bear Stearns the loans or to demand that the entity repurchase the loans if the defects were discovered after purchase. Bear Stearns thus had the means before the closing of the Transactions to assess the quality of the loans and recourse in the event a defect was discovered.

228. In contrast, Ambac was not in privity with and lacked recourse against the originators, never owned the loans or the loan files, and therefore didn't have the opportunity to review the loans before deciding whether to participate in the Transactions. What Ambac did have, however, were Bear Stearns's numerous representations about the loans. Recognizing the critical importance of these representations, Ambac also insisted, as sophisticated parties typically do, that Bear Stearns reduce many of these representations to enforceable warranties in the parties' written agreements. As explained below, Bear Stearns did so. It therefore made sense for the sophisticated parties to agree that Bear Stearns would bear the loan-origination risk, and that Ambac, relying on the truth of Bear Stearns's representations, would bear the market risk.

229. This risk-allocation arrangement enabled each party to conduct the appropriate due diligence consistent and commensurate with the risk each party bore. Bear Stearns purported to carefully vet the originators from which it bought the loans (as part of its seller-approval process), re-underwrite the loans before it purchased the loans (as part of its due-diligence process), and conduct further review of the loans after acquisition (as part of its quality-control process).

230. Ambac, in turn, (i) conducted on-site reviews of Bear Stearns's operations, (ii) secured and evaluated Bear Stearns's representations concerning the seller-approval, due-diligence, quality-control, and repurchase protocols Bear Stearns purportedly performed, (iii) conducted extensive modeling of its exposure to interest rate and other market variables using the loan data represented as true by Bear Stearns, (iv) assessed the adequacy of Bear Stearns's wherewithal to stand behind its representations and warranties, (v) analyzed the represented performance of Bear Stearns's prior securitizations, and, significantly, (vi) secured from Bear Stearns its commitment to provide, through EMC, extensive contractual representations and warranties concerning, among other things, the veracity of the mortgage-loan data that Bear Stearns provided and the underwriting practices followed in the origination of the loans.

231. These numerous representations and warranties that Bear Stearns provided through EMC, and on which Ambac relied, were the means by which the parties effectuated this reasoned risk allocation, and therefore, were an essential inducement for Ambac to participate in the Transactions. In particular, they gave Ambac comfort – both practically and as a matter of law – that even though it couldn't reasonably conduct its own loan-level due diligence of the loans and the underwriting practices followed in originating them, it didn't need to.

VIII. BEAR STEARNS'S EXPRESS REPRESENTATIONS AND WARRANTIES, AND RELATED COVENANTS, WERE A MATERIAL INDUCEMENT TO AMBAC TO PARTICIPATE IN THE TRANSACTIONS AND ISSUE ITS POLICIES

A. EMC'S EXPRESS CONTRACTUAL REPRESENTATIONS AND WARRANTIES THAT EFFECTUATED THE PARTIES' BARGAINED-FOR RISK ALLOCATION

232. Under the agreements that effectuated the Transactions, the principal and interest payments from the loans were to provide the cashflow necessary to make the monthly principal and interest payments due on the Certificates. Ambac's Policies required it to make payments to the purchasers of the Insured Certificates to the extent there was a shortfall of cashflow available from the loans (or, in the case of the BALTA 2006-R1 Transaction, the underlying securities), once the protection provided by subordinated classes of securities and other credit enhancement was eroded. Ambac agreed to assume this risk of payment shortfalls, which presumed the truth of the information that Bear Stearns provided to Ambac regarding the quality of the securitized loans and Bear Stearns's purportedly thorough due-diligence and quality-control practices in reviewing the loans both before and after the Transactions closed. Bear Stearns assumed the risk and the burden of assessing the validity and accuracy of the characteristics and attributes that it represented and warranted the loans possessed, including that the loans were originated pursuant to the relevant underwriting guidelines.

233. To effectuate this reasoned and bargained-for risk allocation, EMC made myriad representations and warranties in the MLPAs regarding, among other things, the attributes of the loans and the practices used to originate, underwrite, and service them ("Loan-Level Warranties"). As demonstrated by their number, scope, and particularity, these Loan-Level Warranties were designed to convey absolute confidence that EMC was standing behind the quality of the loans and, specifically, accepting the risk of loss should any of the loans be found to have been included in the Transactions in violation of any of the Loan-Level Warranties.

EMC represented and warranted as to each of the loans in each of the Transactions that, among other things:

- MLPA § 7(i): "[T]he information set forth in the Mortgage Loan Schedule is true and correct in all material respects and the information provided to the Rating Agencies, including the Mortgage Loan level detail, is true and correct according to the Rating Agency requirements."[173]

- MLPA § 7(iii): "Each Mortgage Loan at the time it was made complied in all material respects with all applicable local, state and federal laws, including, without limitation, . . . all applicable anti-predatory, abusive and fair lending laws."[174]

- MLPA § 7(iv): "[T]here is no monetary default existing under any Mortgage or the related Mortgage Note and there is no material event which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach or event of acceleration; and neither the Mortgage Loan Seller, any of its affiliates nor any servicer of any related Mortgage Loan has taken any action to waive any default, breach or event of acceleration."

- MLPA § 7(vi): "[N]o selection procedure reasonably believed by the Mortgage Loan Seller to be adverse to the interests of the Certificateholders was utilized in selecting the Mortgage Loans."

- MLPA § 7(x): "[T]here is no valid offset, defense or counterclaim to any Mortgage Note or Mortgage, including the obligation of the Mortgagor to pay the unpaid principal and interest on such Mortgage Note."

- MLPA § 7(xiv): "[A]t the time of origination, each Mortgaged Property was the subject of an appraisal which conformed to the underwriting requirements of the originator of the Mortgage Loan and the appraisal is in a form acceptable to Fannie Mae or Freddie Mac."

- MLPA § (xx): "[T]he information set forth in Schedule A of the Prospectus Supplement with respect to the Mortgage Loans is true and correct in all material respects."[175]

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[173] Section 7(i) of the MLPAs for the SAMI 2006-AR7 and SAMI 2006-AR8 Transactions omits the second part of this representation and warranty relating to the rating agencies, but is otherwise the same.

[174] Section 7(iii) of the MLPAs for the GPMF 2006-AR2 and GPMF 2006-AR3 Transactions omits the words "local, state and federal," but is otherwise the same.

[175] This representation and warranty appears in Section 7(xviii) of the MLPAs for the SAMI 2006-AR7 and SAMI 2006-AR8 Transactions, but is otherwise the same. Schedule A of the ProSupps contains more detailed information about, among other things, both LTV ratios and occupancy status of the loans on a pool-wide basis.

- MLPA § 7(xxi): "[E]ach Mortgage Loan was originated in accordance with the underwriting guidelines of the related originator."[176]

- MLPA § 7(xxiv): "[T]he Mortgage Loans are currently being serviced in accordance with accepted servicing practices."[177]

234. EMC also made representations and warranties in the MLPAs regarding all of the loans in each Transaction in the aggregate ("Transaction-Level Warranties"). In particular, EMC represented and warranted in Section 8(vii) of the MLPAs as follows:

> The Mortgage Loan Seller's Information (identified in Exhibit 3 hereof) does not include any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

Exhibit 3 of each MLPA defines the "Mortgage Loan Seller's Information" to include three sections of the ProSupp: (1) "SUMMARY OF TERMS – The Mortgage Pool," (2) "DESCRIPTION OF THE MORTGAGE LOANS," and (3) "SCHEDULE A – Certain Characteristics of the Mortgage Loans." The "SUMMARY OF TERMS" section of the ProSupps contains, among other things, weighted-average LTV ratios for each pool of loans in the Transactions. "SCHEDULE A" of the ProSupps contains more detailed information about, among other things, both LTV ratios and occupancy status of the loans on a pool-wide basis.

235. Ambac is a third-party beneficiary of the MLPAs with the right to enforce breaches of both the Loan-Level Warranties and the Transaction-Level Warranties against EMC for all Transactions other than the BALTA 2006-R1 Transaction. The material misrepresentations and omissions by Bear Stearns detailed at length in this complaint constitute a

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[176] This representation and warranty appears in Section 7(xx) of the MLPAs for the SAMI 2006-AR7 and SAMI 2006-AR8 Transactions and Section 7(xxiv) of the MLPA for the GPMF 2006-AR2 Transaction, but is otherwise the same.

[177] This representation and warranty appears in Section 7(xxiii) of the MLPAs for the SAMI 2006-AR7 and SAMI 2006-AR8 Transactions and Section 7(xxvii) of the MLPA for the GPMF 2006-AR2 Transaction, but is otherwise the same.

breach of the Transaction-Level Warranties. In addition, the facts alleged as to the rampant misrepresentations of incomes, liabilities, and occupancy status permeating the loans in the Transactions, and the failure of the loans in the Transactions to otherwise comport with the represented attributes and the applicable underwriting guidelines, also constitute breaches of one or more of the Loan-Level Warranties with respect to a significant percentage of the loans in the Transactions.

B. EMC'S CONTRACTUAL COVENANTS REINFORCING THE PARTIES' BARGAINED-FOR RISK ALLOCATION

1. EMC's Promise to Give Prompt Notice of Breaches

236. To reinforce the parties' bargained-for risk allocation and to further assure the Transactions' participants that the loans complied with EMC's representations and warranties, the MLPAs provide ongoing obligations on all securitization participants to promptly disclose any loan found to have been included in the Transactions in violation of any of EMC's myriad Loan-Level Warranties.

237. Specifically, Section 7 of the MLPAs provide, in relevant part, as follows:

> Upon discovery or receipt of notice by the Mortgage Loan Seller [EMC], the Purchaser [a Bear Stearns affiliate], the Certificate Insurer [Ambac], the Trustee or the Custodian, as its agent, of a breach of any representation or warranty of [EMC] set forth in this Section 7 which materially and adversely affects the value of the interests of the Purchaser, the Certificateholders, [Ambac], or the Trustee in any of the Mortgage Loans . . . , the party discovering or receiving notice of such breach shall give prompt written notice to the others.[178]

238. The notification provisions are absolute; they are in no way conditioned on EMC's ability to pursue claims against the originators of breaching loans or ultimately cure the

[178] SAMI 2006-AR7 and SAMI 2006-AR8 MLPAs. Although the MLPAs for the other Transactions do not mention Ambac, as the "Certificate Insurer," in this notice provision, they do make Ambac an explicit third-party beneficiary of the entire agreements with rights to enforce the agreements' provisions, including this notice provision and the related repurchase protocol, discussed below.

defects affecting those loans. Instead, they are designed to give prompt notice to the Transactions' participants of any breaching loan to ensure that EMC – and not Ambac, the Transactions, or its investors – bear the risk of loss associated with defective loans that EMC should not have securitized.

239. EMC's promise to promptly notify other Transaction participants of breaching loans subsequently found to have been included in the Transactions was also a material inducement of Ambac's and investors' participation in the Transactions.

2. EMC's Promise to Repurchase or Cure Breaching Loans Within 90 Days

240. Disclosing the existence of breaching loans identified in the Transactions was necessary and essential to enforcing EMC's express contractual obligation to repurchase those loans or cure the breach in a timely manner (*i.e.*, within 90 days) – and, thus, minimize the risk of loss to the Transactions' investors and Ambac in the event Bear Stearns securitized defective loans by allocating that risk squarely to EMC.

241. To carry out this bargained-for risk allocation, and to convey absolute confidence that EMC was standing behind the quality of the securitized loans, EMC agreed in the MLPAs that, should any of its Loan-Level Warranties prove untrue, it would cure the breach(es) or remove the breaching loan(s) from the securitization trusts (the "repurchase protocol"). To this end, immediately following the notification obligations described above, Section 7 of the MLPAs for the Transactions provides, in pertinent part, as follows:

> In the case of any such breach of a representation or warranty set forth in this Section 7, within 90 days from the date of discovery by [EMC], or the date [EMC] is notified by the party discovering or receiving notice of such breach (whichever occurs earlier), [EMC] will (i) cure such breach in all material respects [or] (ii)

purchase the affected Mortgage Loan at the applicable Purchase Price.[179]

IX. EMC'S PERVASIVE BREACHES OF ITS REPRESENTATIONS AND WARRANTIES

A. AMBAC'S LOAN-LEVEL REVIEW UNCOVERED PERVASIVE BREACHES

242. As noted above, Ambac recently obtained loan files for two of the Transactions: GPMF 2006-AR3 and BSMF 2006-AR2. To date, Ambac, through its independent consultant, has reviewed 50 loans from each of these two Transactions. The results of Ambac's loan-level reunderwriting revealed breaches of one or more of EMC's representations and warranties for 45 of the loans from GPMF 2006-AR3 and 40 of the loans from BSMF 2006-AR2—evidencing staggering breach rates of 90% and 80%, respectively. These loans contain one or, in most cases, more than one defect that constitute a breach of one or more of the numerous representations and warranties made by EMC in the applicable MLPA and materially altered the loans' risk profile. These defects include:

- rampant fraud, primarily involving misrepresentation of the borrower's income, liabilities, employment, or intent to occupy the property as the borrower's primary residence;
- inadequately supported property values;
- pervasive violations of the applicable underwriting guidelines and prudent mortgage-lending practices, including loans made to borrowers (i) who made unreasonable claims as to their income or otherwise clearly had no ability to repay their loans, (ii) with credit scores below the required minimum, (iii) with LTV ratios above the allowed maximum, or (iv) with relationships to the lender or originator or other non-arm's-length relationships.

[179] BSMF 2006-AR2 and BSMF 2006-AR4 MLPAs. The MLPAs for each of the other Transactions contains materially identical language. In addition to the "cure" and "repurchase" options, the MLPAs also provide for a "substitution" option (allowing EMC to substitute a non-breaching loan for a breaching loan), but that option exists only within two years of closing and is therefore no longer available to EMC with respect to any of the Transactions.

243. Each of these breaches adversely affected Ambac's interests, and materially and adversely affected the value of the interest of the Certificateholders in the identified loans. Loans that were subject to fraud, loans that were not originated pursuant to applicable guidelines, or loans for which the key attributes were otherwise misrepresented are markedly riskier and therefore less valuable than loans not suffering from such shortcomings.

244. On April 9, 2012, pursuant to Section 7 of the MLPAs, Ambac gave formal notice to EMC and the other deal participants identifying the breaching loans found to have been included in the GMPF 2006-AR3 and BSMF 2006-AR2 Transactions, and describing with specificity the breach, or breaches, affecting those loans. The trustee, in turn, provided these notices to EMC and the other deal participants on April 25, 2012. Upon receipt of such notices, EMC became obligated under the applicable MLPAs to repurchase or cure the affected loans within 90 days.

245. EMC refused to repurchase any of the loans or acknowledge the breaches in what amounts to a deliberate and bad-faith frustration of the repurchase protocol further compounding the massive harm inflicted by Bear Stearns on Ambac and the Transactions' investors.

246. By its wholesale rejection of Ambac's repurchase demands, EMC has thus made clear that it has no intention of honoring its contractual obligations.

X. HARM SUFFERED BY AMBAC AND CERTIFICATEHOLDERS

247. The Transactions that Bear Stearns marketed and effectuated based on its materially false and misleading representations and disclosures have failed miserably. An overwhelming percentage of the loans that Bear Stearns securitized in each of the Transactions either have defaulted or are severely delinquent, causing massive shortfalls in the cashflows of principal and interest needed to pay down the Certificates. As a result, the Certificateholders have incurred severe losses that have been passed on to Ambac as the financial guarantor.

248. With respect to the loan groups backing the Insured Certificates, the Transactions have experienced cumulative losses of more than $1.8 billion as of February 29, 2012. A significant portion of the loans in those loan groups have defaulted or are severely delinquent, as reflected in the following table:

Transaction	**Cumulative Losses**	**% of Loans Severely Delinquent, Liquidated, in Foreclosure, Bankruptcy, or REO (by Loan Balance)**
GPMF 2006-AR2	$85.5 million	42.31%
GPMF 2006-AR3	$202.9 million	46.29%
SAMI 2006-AR7	$508.6 million	61.68%
SAMI 2006-AR8	$328.4 million	55.36%
BALTA 2006-R1	$441.1 million	41.40%
BSMF 2006-AR2	$118.6 million	49.38%
BSMF 2006-AR4	$141.4 million	48.93%

249. The severe losses realized by the Transactions have resulted in Ambac being obligated to make claim payments to insured Certificateholders. As of February 29, 2012, Ambac has paid, or is obligated to pay, claims of more than $200 million in the aggregate.

250. Due to the high rate of delinquency and expected defaults, future borrower re-payment shortfalls affecting the Transactions are inevitable. Therefore, in addition to the substantial claims that Ambac has paid and is obligated to pay under its Policies, Ambac expects hundreds of millions of dollars in additional claims in the future.

251. As discussed above, Bear Stearns's fraudulent statements and material omissions, and the pervasive breaches of EMC's representations and warranties, revealed by Ambac's loan-level reviews, Bear Stearns's internal documents, and confidential-witness statements and testimony, and corroborated by the dismal loan performance in all of the Transactions, pierce the very heart of the bargain struck by the parties. As has only recently become clear, Bear Stearns

did not sell to the trusts for the Transactions the contemplated portfolio of loans with the represented attributes. Rather, Bear Stearns transferred pools where the overwhelming majority of loans did not bear any resemblance to the loans Bear Stearns represented would comprise the pools. In doing so, Bear Stearns induced Ambac into insuring each successive Transaction based upon materially false and misleading information about that Transaction and the ones preceding it.

252. The Offering Documents that Bear Stearns prepared to market the Certificates that Ambac insured (and the same documents that it filed with the SEC) contained material misrepresentations and omissions because, like the loan tapes, they did not adequately or accurately disclose the true attributes of the loans (*e.g.*, LTV ratios and occupancy status), the level of fraud and underwriting failings permeating the EMC loan pools, the grossly deficient origination practices of the originators of these loans, Bear Stearns's dismal due-diligence practices, the duplicitous role of its quality-control department, or its scheme to recover from originators and pocket substantial sums of money that rightfully belonged to the securitization trusts (*i.e.*, Ambac and the investors). Ambac never would have issued its Policies or agreed to participate in the Transactions had it known the truth.

253. Bear Stearns's misconduct entitles Ambac to be, among other things, (i) returned to the position it would have been in had it not issued its Policies and (ii) compensated for the incremental harm incurred as a result of its participation in each of the Transactions. At the very least, this relief requires the payment to Ambac of all claims payments made and accrued to date and all future claims payments required to be made under its Policies.

XI. EMC WAS A MERE ALTER EGO AND INSTRUMENTALITY OF BEAR, STEARNS & CO.

254. Throughout the time prior to JP Morgan's acquisition of Bear, Stearns & Co., Bear, Stearns & Co. exercised exclusive and complete domination and control over EMC both generally and specifically with respect to the Transactions.

255. As noted above, Bear, Stearns & Co.'s investor presentations answered the question "Why purchase RMBS from Bear Stearns?" by referring to the "Integral role played by Bear Stearns' affiliate, EMC Mortgage Corporation (EMC)," including the representations and warranties offered by EMC. But EMC did not operate separately from Bear, Stearns & Co. Instead, EMC was a sham entity with no legitimate business purpose other than to shield Bear, Stearns & Co. from liability for its fraudulent RMBS products.

256. Bear, Stearns & Co. directly pitched the Transactions to Ambac as Bear, Stearns & Co. products. Bear, Stearns & Co. conducted all negotiations with Ambac for the Transactions and provided all information regarding the Transactions to Ambac. Moreover, the commitment letters for the Transactions – which are the agreements obligating Ambac to issue its Policies on the Transactions – were entered into with Bear, Stearns & Co., not EMC. These commitment letters obligated EMC to enter into the agreements effectuating the Transactions (such as the MLPAs and PSAs).

257. Bear, Stearns & Co. held out EMC as an adequately capitalized corporation capable of backing the representations and warranties it made to Bear Stearns's securitization participants, including Ambac. But EMC was not adequately capitalized for its corporate undertaking, as it did not set sufficient reserves for its repurchase liabilities to securitization

trusts, including with respect to the Transactions.[180] Indeed, Bear, Stearns & Co. siphoned off EMC's corporate funds to offset losses on Bear, Stearns & Co.'s trading books, as if the funds belonged to Bear, Stearns & Co.[181] In sum, Bear, Stearns & Co. operated EMC as a mere instrumentality, which it used to defraud Ambac as well as investors in the Transactions while shielding itself from liability.

258. Accordingly, equity requires that JP Morgan, as successor to Bear, Stearns & Co., be held accountable and liable for the actions and wrongs of EMC.

XII. JPMORGAN CHASE & CO. HAS STRIPPED EMC OF ITS ASSETS, SEEKING TO RENDER EMC A JUDGMENT-PROOF SHELL, BUT SUBJECTING JPMC BANK TO SUCCESSOR LIABILITY

259. JPMorgan Chase & Co. has recently taken steps to strip EMC (which was already undercapitalized) of its assets and render it unable to satisfy any judgment against it. On or about April 1, 2011, JPMorgan Chase & Co. effectuated an intercompany asset sale whereby EMC transferred to its affiliate, JPMC Bank, all of EMC's servicing-related assets (the "Asset Transfer"). The mortgage-servicing business entails processing payments from borrowers for securitized loans, such as those included in the Transactions, and distributing the proceeds to the securitization trusts, as well as pursuing delinquent borrowers and bringing foreclosure actions.

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[180] *See* Assured Complaint ¶ 302 (citing EMC Mortgage Corporation and Subsidiaries, Independent Auditors' Report, Consolidated Financial Statements as of and for the Years Ended November 30, 2006 and 2005, EMC-AMB 012128918-947. With respect to claims by EMC against sellers, "[t]he Company evaluates seller obligations to the Company and reserves for any seller obligation that the Company deems uncollectible." *Id.* at 943. But, with respect to EMC's own liability for its representation-and-warranty breaches to securitization counterparties, "[t]he contingencies triggering the obligation to indemnify are not generally expected to occur," and "it is unlikely that the Company will have significant losses under these arrangements." *Id.* *See also* 10/3/2011 Marano Deposition Tr. at 123 ("I do not recall [EMC] establishing reserves for breaches of rep and warranty on securitization trusts.")).

[181] *See* Assured Complaint ¶ 302 (citing EMC Mortgage Corp. Claims Settlements Report for the month ending 11/30/2006, EMC-AMB 003673312 (allocating $6.7 million in cash obtained by EMC in claims settlements with sellers to offset markdown losses on Bear, Stearns & Co.'s FIXED and ARMS trading desks, led by Jeff Verschleiser and Michael Nierenberg, respectively); 10/6/2011 Verschleiser Deposition Tr. at 83-84 ("EMC was a subsidiary of Bear Stearns so if there was a fee earned, it was just an intercompany transfer. . . . ***[I]t's just one pocket to the other***.")).

The servicing assets transferred in the Asset Transfer include servicing rights on four of the Transactions at issue in this litigation, several other Ambac-insured securitizations, and dozens of other securitizations. The servicing operation that EMC sold to JPMC Bank constituted substantially all of EMC's assets and its last remaining operating asset. EMC has been shorn of its assets and has become, in essence, a shell. By taking these improper actions, JPMorgan Chase & Co. has subjected its subsidiary, JPMC Bank, to liability as EMC's successor.

A. EMC'S PAST SERVICING OPERATIONS

260. EMC acted as a servicer in connection with four of the Transactions at issue in this litigation. At the time of the Transactions, servicing was one of EMC's several business operations, and one that Bear Stearns featured prominently in its discussions with Ambac. As explained above, EMC also specialized in the acquisition, securitization, and disposition of mortgage loans. But by the time of the Asset Transfer in early 2011, JPMorgan Chase & Co. had shut down EMC's mortgage-loan acquisition and securitization operations. Servicing was EMC's last remaining business operation, and its servicing business constituted EMC's last remaining substantial asset.

B. AMBAC'S CONTRACTUAL RIGHTS TO SUE ANY SUCCESSOR OF EMC

261. The Asset Transfer has resulted in JPMC Bank becoming liable to Ambac for all obligations of EMC, including the repurchase of all breaching loans, as EMC's successor under the "Successor and Assigns" provisions of the MLPAs governing the Transactions. Pursuant to Section 23 of the MLPAs for all of the Transactions, "[a]ny person into which [EMC] may be merged or consolidated (or any person resulting from any merger or consolidation involving [EMC]), any person resulting from a change in form of [EMC] or any person succeeding to the

business of [EMC], shall be considered a 'successor' of [EMC] hereunder and shall be considered a party hereto."

262. Because the servicing business was EMC's sole remaining ongoing operating business, when JPMC Bank succeeded to that business through the Asset Transfer, it succeeded to EMC's obligations with respect to the Transactions pursuant to the plain terms of the MLPAs.

C. JPMORGAN CHASE & CO. EFFECTUATED A *DE FACTO* MERGER OF EMC AND JPMC BANK

263. In addition to making JPMC Bank EMC's successor by operation of these contractual provisions, the Asset Transfer orchestrated by the two entities' mutual parent company, JPMorgan Chase & Co., also resulted in JPMC Bank becoming liable for all of the obligations and liabilities of EMC – including with respect to all of the Transactions – by operation of law. Ultimate ownership of the servicing operations that EMC transferred remains unchanged: Both before and after the Asset Transfer, EMC and JPMC Bank were affiliates of the same banking family and ultimately owned by the same parent holding company, JPMorgan Chase & Co.

264. In addition, EMC has ceased independent business operations. Before being recently removed from the Internet, EMC's website described EMC as "a brand of JPMorgan Chase Bank, N.A.,"[182] and stated that "JPMorgan Chase Bank, N.A. services loans under the EMC Mortgage name."[183] EMC no longer services mortgage loans, and no longer engages in any other business operations.

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[182] EMC Mortgage® A Brand of JPMorgan Chase Bank, N.A., https://www.emcmortgagecorp.com/EMCMORTGAGE/ (last visited July 18, 2011).

[183] EMC Mortgage® A Brand of JPMorgan Chase Bank, N.A., About Us, https://www.emcmortgagecorp.com/EMCMORTGAGE/MainContent/about_us.jsp (last visited July 18, 2011).

265. JPMC Bank has assumed the obligations necessary for the uninterrupted continuation of the operations performed by EMC prior to the Asset Transfer. Specifically, JPMC Bank has assumed EMC's obligations to service mortgage loans under the contracts governing various RMBS deals, including four of the Transactions at issue in this litigation.

266. JPMC Bank has retained EMC's management and personnel, as well as EMC's physical locations and, as noted, EMC's assets and general business operations. After the Asset Transfer, EMC's former management and personnel continue to handle the transferred servicing operations from the same business locations. EMC's former servicing operations located in Dallas, Texas − now belonging to JPMC Bank − are continuing to handle payment processing, borrower inquires, and related functions.[184]

267. In short, the Asset Transfer constituted a *de facto* merger of EMC and JPMC Bank, making JPMC Bank liable as a successor for all of EMC's obligations and liabilities by operation of law.

FIRST CAUSE OF ACTION

(Against Defendants JP Morgan, as successor to Bear, Stearns & Co., and EMC for Fraudulent Inducement)

268. Plaintiff realleges and incorporates by reference paragraphs 1 through 267 of this Complaint.

269. As set forth above, Defendants JP Morgan (formerly Bear, Stearns & Co.) and EMC made materially false public statements, and omitted material facts, with the intent to defraud the public and Ambac.

[184] EMC Mortgage® A Brand of JPMorgan Chase Bank, N.A., Contact Us, https://www.emcmortgagecorp.com/EMCMORTGAGE/MainContent/contact_us.jsp (last visited July 18, 2011).

270. Defendants made materially false statements and omitted material facts with the intent to defraud Ambac in pre-contractual communications between Ambac and Defendants' officers and other employees.

271. Defendants, knowingly and with the intent to defraud, delivered to Ambac materially false and misleading documentation, including investor presentations, loan tapes, and Offering Documents, and fraudulently induced ratings by the rating agencies.

272. Ambac reasonably relied on Defendants' statements and omissions when it issued its Policies.

273. As a result of Defendants' statements and omissions, Ambac insured securities backed by pools of loans that had a risk profile far greater than Defendants led Ambac to believe.

274. As a result of Defendants' false and misleading statements and omissions, Plaintiff has suffered, and will continue to suffer, damages in an amount to be determined at trial.

275. Because Defendants committed these acts and omissions maliciously, wantonly, oppressively, and with knowledge that they would affect the general public – which they have – Plaintiff is entitled to punitive damages.

SECOND CAUSE OF ACTION
(Against Defendants JP Morgan, as successor to Bear, Stearns & Co., and EMC for Breaches of Representations and Warranties)

276. Plaintiff realleges and incorporates by reference paragraphs 1 through 275 of this Complaint.

277. EMC induced Ambac to issue its Policies by, among other things, making the Loan-Level Warranties and Transaction-Level Warranties in the MLPAs.

278. Each MLPA is a valid and binding agreement between EMC and the Depositor of the Transactions.

279. Ambac is a third-party beneficiary of each MLPA.

280. EMC has materially breached the Transaction-Level Warranties set forth in Section 8(vii) of the MLPAs.

281. As a result of EMC's breaches, Ambac has been damaged and will continue to be damaged in an amount to be determined at trial.

THIRD CAUSE OF ACTION
(Against Defendants JP Morgan, as successor to Bear, Stearns & Co., and EMC for Breaches of the Repurchase Obligation)

282. Plaintiff realleges and incorporates by reference paragraphs 1 through 281 of this Complaint.

283. EMC induced Ambac to issue its Policies by, among other things, making the Loan-Level Warranties and Transaction-Level Warranties in the MLPAs.

284. Each MLPA is a valid and binding agreement between EMC and the Depositor of the Transactions.

285. Ambac is a third-party beneficiary of each MLPA.

286. EMC has materially breached the Loan-Level Warranties set forth in Section 7 of the MLPAs.

287. EMC has materially breached its obligations under Section 7 of the MLPAs by refusing to cure or repurchase the loans that breached EMC's Loan-Level Warranties and with respect to which (i) EMC had discovered the breach or (ii) notice of breach has been provided by Ambac to EMC.

288. As a result of EMC's breaches, Ambac has been damaged and will continue to be damaged in an amount to be determined at trial.

FOURTH CAUSE OF ACTION
(Against Defendant JPMC Bank for Successor Liability)

289. Plaintiff re-alleges and incorporates by reference paragraphs 1 through 288 of this Complaint.

290. JPMC Bank is liable for any and all damages resulting from the wrongful actions of EMC, as alleged herein, because as a matter of law JPMC Bank is the successor to EMC both contractually under the Transaction Documents and as a result of the *de* facto merger of JPMC Bank and EMC resulting from EMC's Asset Transfer to JPMC Bank on or about April 1, 2011, wherein JPMC Bank acquired all or substantially all of EMC's assets.

291. JPMC Bank is a person that has succeeded to the business of EMC. As a result, JPMC Bank is the successor to EMC under the MLPAs governing the Transactions and automatically became a party to the MLPAs in accordance with their terms at the time of the Asset Transfer.

292. In addition, JPMC Bank is the successor to all of the obligations and liabilities of EMC by operation of law as a consequence of the *de facto* merger of JPMC Bank and EMC resulting from the Asset Transfer.

293. After the Asset Transfer, there remains continuity of ownership of EMC and JPMC Bank. Both before and after the Asset Transfer, EMC and JPMC Bank were ultimately owned and controlled by the same parent holding company, JPMorgan Chase & Co.

294. EMC has ceased its ordinary business operations. After the Asset Transfer, JPMC Bank services loans under the "EMC Mortgage" name.

295. JPMC Bank has assumed the liabilities necessary for the uninterrupted continuation of the operations performed by EMC prior to the Asset Transfer. Specifically,

JPMC Bank has assumed EMC's obligations to service mortgage loans under the contracts governing various RMBS deals, including four of the Transactions at issue in this litigation.

296. JPMC Bank has retained EMC's management and personnel, as well as EMC's physical locations, assets, and general business operations. After the Asset Transfer, JPMC Bank has continued the servicing operations once belonging to EMC using EMC's employees, management, and facilities.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

- For an award of all legal, equitable, and punitive damages, including all of Plaintiff's claims paid or due for payment in the future under its Policies, and any other present and future damages to be proven at trial, against Defendants for their fraudulent inducement of Ambac's participation in the Transactions and issuance of its Policies;
- For an award of compensatory, consequential, and/or equitable damages, including all of Plaintiff's claims paid or due for payment in the future under its Policies, and any other present and future damages to be proven at trial, against Defendants for their pervasive and material breaches of representations and warranties and failure to comply with their obligations to cure or repurchase the loans that breach these representations and warranties, constituting a material breach of the MLPAs, and frustration of the parties' bargain;
- For an order compelling EMC to comply with its obligations under MLPA § 7 in each Transaction to cure or repurchase the loans that breach its representations and warranties;
- For an Order of prejudgment interest;
- For an Order holding JPMC Bank liable as EMC's successor to pay in full any award of damages in this case for which EMC may be liable to Ambac; and
- For an Order awarding Plaintiff such other and further relief as the Court deems just and proper.

Dated: New York, New York
August 14, 2012

Respectfully Submitted,

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