

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

BAYERISCHE LANDESBANK, NEW YORK  
BRANCH,

Plaintiff,

v.

MERRILL LYNCH & CO., MERRILL  
LYNCH, PIERCE, FENNER & SMITH INC.,  
MERRILL LYNCH MORTGAGE  
INVESTORS, INC., and MERRILL LYNCH  
MORTGAGE LENDING, INC.

Defendants.

Index No.

**COMPLAINT**

**JURY TRIAL DEMANDED**

## TABLE OF CONTENTS

	<u>Page</u>
I. SUMMARY OF THE ACTION.....	1
II. JURISDICTION AND VENUE.....	4
III. THE PARTIES.....	4
A. Plaintiff.....	4
B. Defendants.....	5
IV. FACTUAL BACKGROUND UNDERLYING BAYERNLB’S CLAIMS.....	6
A. The Merrill Lynch RMBS Purchased By BayernLB.....	6
B. Merrill Lynch’s Activities In The Subprime Mortgage Arena.....	10
C. Merrill Lynch’s Role Was To Ensure The Quality Of The Loans Backing The RMBS.....	11
D. Factors Impacting The Quality Of The Merrill Lynch RMBS.....	13
V. THE OFFERING MATERIALS MISREPRESENTED THE UNDERWRITING AND QUALITY OF THE LOANS BACKING THE MERRILL LYNCH RMBS.....	18
VI. MERRILL LYNCH KNEW THE TRUTH ABOUT THE ORIGINATORS’ LENDING PRACTICES AND THE FALSITY OF THE CREDIT RATINGS ASSIGNED TO ITS RMBS.....	22
VII. DEFENDANTS’ FALSE AND MISLEADING MISSTATEMENTS AND OMISSIONS OF MATERIAL FACT IN THE OFFERING DOCUMENTS.....	26
VIII. BAYERNLB’S INVESTMENT IN THE RMBS AND RELIANCE ON MERRILL LYNCH’S MISREPRESENTATIONS.....	29
IX. BECAUSE OF DEFENDANTS’ FRAUDULENT CONDUCT, BAYERNLB SUFFERED LOSSES ON THE RMBS BAYERNLB PURCHASED.....	32
FIRST CAUSE OF ACTION (Common Law Fraud Against All Defendants).....	32
SECOND CAUSE OF ACTION (Fraudulent Inducement Against All Defendants).....	34
THIRD CAUSE OF ACTION (Aiding And Abetting Fraud Against All Defendants).....	35
FOURTH CAUSE OF ACTION (Negligent Misrepresentation Against All Defendants).....	36
PRAYER FOR RELIEF.....	39

Plaintiff Bayerische Landesbank, New York Branch (“BayernLB” or “Plaintiff”), by its attorneys Bernstein Litowitz Berger & Grossmann LLP, for its Complaint herein against Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith Inc., Merrill Lynch Mortgage Investors, Inc., and Merrill Lynch Mortgage Lending, Inc. (collectively, “Merrill Lynch” or “Defendants”), alleges as follows:

**I. SUMMARY OF THE ACTION**

1. This action arises from a fraud perpetrated by Merrill Lynch against BayernLB, which acquired residential mortgage-backed securities (“RMBS”) backed by loans purchased, financed, and securitized by Merrill Lynch. Those investments, in highly-rated RMBS bearing investment grade ratings, were made in reliance on Merrill Lynch’s representations that the mortgages backing the RMBS were originated according to specific underwriting guidelines and were collateralized by accurately appraised properties. Those representations and the investment grade ratings the RMBS carried led BayernLB to believe that the Merrill Lynch RMBS were safe investments.

2. BayernLB asserts claims on over \$324 million of Merrill Lynch RMBS purchased in 13 offerings between 2006 and 2007 (the “Certificates”) in reliance on registration statements, prospectuses, draft prospectus supplements, prospectus supplements, term sheets, and related communications between Merrill Lynch and BayernLB (the “Offering Materials”) prepared by and provided to BayernLB, directly or indirectly, by Defendants. The Offering Materials contained numerous representations about the purportedly conservative mortgage underwriting standards applied by the mortgage originators, the appraisals of the mortgaged properties, the due diligence conducted by Merrill Lynch, and other facts regarding the collateral underlying the RMBS that were material to the investment decisions. The decisions to purchase the Certificates were made in reliance on those representations.

3. In particular, for many securitizations, Merrill Lynch represented that it had conducted due diligence on the mortgage originators before purchasing for securitization the loans the originators issued, providing assurance that the loans backing the RMBS in which BayernLB invested conformed to the stated underwriting standards, that the appraisal values and other characteristics were valid and accurate, that the Certificates were deserving of the investment grade ratings they had been assigned, and that the quality of the RMBS as represented in the Offering Materials matched Merrill Lynch's reputation.

4. In truth, and as BayernLB and the world would only later discover, the originators whose loans collateralized the Merrill Lynch RMBS at issue were among the worst of the worst culprits in the subprime lending industry. These originators have since folded up their operations, filed for bankruptcy or been shut down by regulators, and are the subject of numerous governmental investigations and private lawsuits alleging misconduct arising out of pervasive illegal and improper mortgage lending practices and other violations of law.

5. Merrill Lynch knew or recklessly disregarded that those lenders were issuing high-risk loans that did not conform to their respective underwriting standards. Merrill Lynch did, in fact, conduct extensive due diligence on the loans backing its RMBS. In the course of that extensive due diligence process, which, in many instances, included an extensive re-underwriting review of the loans it purchased by an independent third-party due diligence provider, Clayton Holdings, Inc. ("Clayton"), Merrill Lynch learned that the originators routinely and flagrantly disregarded their own underwriting guidelines, originated loans based on wildly inflated appraisal values, and manipulated the underwriting process in order to issue to borrowers loans who had no plausible means to repay them. Indeed, the President of Clayton testified as to the extensive deficiencies identified through Merrill Lynch's due diligence. Specifically, almost *one-fourth* of the loans Merrill Lynch evaluated for purchase and

securitization at the height of the mortgage boom (from 2006 through mid-2007) failed to meet the originators' own underwriting guidelines.

6. In fact, between January 2006 and June 2007, Merrill Lynch purchased and securitized almost *one-third* of the sampled loans that Clayton determined failed to meet the originators' underwriting guidelines, meaning that Merrill Lynch knew the loan pools it securitized were riddled with defective loans that were underwritten in a systematically deficient manner that flatly contradicted the representations in Merrill Lynch's Offering Materials. Moreover, despite knowing that almost one-fourth of the sample set of loans it scrutinized did not meet underwriting guidelines, Merrill Lynch securitized the remainder of the un-sampled loans, even though it knew, or recklessly disregarded the risk, that one-fourth of those loans also did not meet underwriting guidelines.

7. Because Merrill Lynch never disclosed these practices, BayernLB was not compensated for the additional risks that it unknowingly took on in purchasing the Merrill Lynch RMBS. Had BayernLB known the truth regarding Merrill Lynch's practices, it would not have purchased the RMBS.

8. Merrill Lynch not only concealed from investors the truth about the poor quality of the securitized loans, Merrill Lynch also knowingly provided false information to the credit rating agencies in order to secure investment grade ratings for its RMBS. Merrill Lynch also exploited its powerful influence over the rating agencies to obtain the desired ratings. As a result of these practices, Merrill Lynch knew that the ratings assigned to its securitizations did not reflect the true credit quality of the Certificates.

9. This misconduct has resulted in astounding rates of default on the loans underlying the Merrill Lynch RMBS and massive downgrades of the Certificates, which are all now considered "junk" by at least one credit rating agency. As such, the Merrill Lynch RMBS

held by BayernLB are no longer marketable or salable at or near the prices paid for them, and BayernLB has suffered substantial losses as a result. Because of Defendants' fraudulent conduct as described herein, the true value of the Merrill Lynch RMBS was worth far less than the prices BayernLB paid.

10. BayernLB seeks compensatory and/or rescissory damages against Defendants for fraud, fraud in the inducement, aiding and abetting fraud, and negligent misrepresentation.

## **II. JURISDICTION AND VENUE**

11. Jurisdiction is proper because Defendants' and Plaintiff are domiciled in New York County, as detailed below, and because each of the Defendants regularly and systematically transacts business within the State of New York within the meaning of CPLR § 302(a)(1), and each of them committed a tortious act inside the State of New York or outside the State of New York causing injury within the State of New York within the meaning of CPLR §§ 302(a)(2) and 302(a)(3). The amount in controversy exceeds \$150,000.

12. Venue is proper in this Court because Plaintiff maintains its principal place of business in New York County, and Defendants maintain their principal places of business in New York County, as detailed below.

## **III. THE PARTIES**

### **A. Plaintiff**

13. Plaintiff Bayerische Landesbank, New York Branch is licensed by the Office of the Comptroller of the Currency with an office located in New York, New York. BayernLB operates as a branch of Bayerische Landesbank. BayernLB purchased the RMBS at issue in this action and acted as referral agent, liquidity agent, administrative agent, and liquidity bank for an asset backed commercial paper conduit, Giro Funding US Corporation, which also invested in RMBS.

14. BayernLB and Giro Funding US Corporation purchased the RMBS described herein. Giro Funding US Corporation transferred the RMBS it had previously purchased, including all rights, title and interests, to BayernLB pursuant to liquidity draws under an Amended and Restated Liquidity Asset Purchase Agreement dated May 15, 2001.

**B. Defendants**

15. Defendant Merrill Lynch & Co. is a Delaware corporation with its principal executive office located at 4 World Financial Center, 250 Vesey Street, New York, New York 10080, and is the ultimate parent corporation of the Merrill Lynch Defendants, as defined below. Merrill Lynch & Co., through its subsidiaries, underwrites securities and derivatives across a broad range of asset classes and serves as a strategic advisor to corporations, governments, institutions and individuals, worldwide. On January 1, 2009, Merrill Lynch & Co. became a wholly owned subsidiary of Bank of America Corporation.

16. Defendant Merrill Lynch, Pierce, Fenner & Smith Inc. is a Delaware corporation and registered broker-dealer with its principal place of business located at 4 World Financial Center, 250 Vesey Street, New York, New York 10080. Merrill Lynch, Pierce, Fenner & Smith Inc. served as lead underwriter for each of the offerings at issue here.

17. Defendant Merrill Lynch Mortgage Investors, Inc., is a Delaware corporation with its principal place of business located at 4 World Financial Center, 250 Vesey Street, New York, New York 10080. Merrill Lynch Mortgage Investors, Inc. served as depositor for nine of the offerings at issue here. Merrill Lynch Mortgage Investors, Inc. is an indirect subsidiary of defendant Merrill Lynch & Co.

18. Defendant Merrill Lynch Mortgage Lending, Inc. is a Delaware corporation with its principal place of business located at 4 World Financial Center, 250 Vesey Street, New York, New York 10080. Merrill Lynch Mortgage Lending, Inc. served as sponsor for eight of

the offerings at issue here and is an affiliate, through common parent ownership, of Merrill Lynch, Pierce, Fenner & Smith Inc.

19. The Defendants identified above are hereinafter collectively referred to as “Merrill Lynch” or “Defendants.”

#### **IV. FACTUAL BACKGROUND UNDERLYING BAYERNLB’S CLAIMS**

##### **A. The Merrill Lynch RMBS Purchased By BayernLB**

20. RMBS, such as the Merrill Lynch RMBS purchased by BayernLB, provide the RMBS investor with an interest in income generated by a pool of mortgages. The actual securities themselves represent a participating interest in an “issuing trust” that holds the mortgage loan pool. Although the structure and underlying collateral of the mortgages varies among the 13 Merrill Lynch RMBS that BayernLB purchased, they all function in a similar manner: The cash from the borrowers who make interest and principal payments on the individual mortgages comprising the mortgage pool is “passed through” to the certificate holders, like BayernLB. Accordingly, failure by those borrowers to make their mortgage payments directly impacts the returns BayernLB earns on its investment. Moreover, a default resulting in foreclosure may cause the trust to sell the subject property at a loss – a risk that increases when the appraisals utilized in underwriting the loans overstated the value of the property that serves as collateral for the mortgage. For these reasons, the proper underwriting of the mortgages underlying the RMBS – including verifying the credit quality of the borrower and the value of the real estate – is essential to ensuring that the RMBS perform according to the representations made to investors like BayernLB.

21. The first step in creating an RMBS is the acquisition by a “depositor” of an inventory of loans from a “sponsor” or “seller,” which either originates the loans or acquires the loans from other mortgage originators, in exchange for cash. The type of loans in the inventory



varies, and can include conventional, fixed-rate or adjustable-rate mortgage loans, secured by first liens, junior liens, or a combination of first and junior liens, with various lifetimes to maturity. The depositor then transfers, or deposits, the acquired pool of loans to an “issuing trust.” In eight of the 13 Merrill Lynch RMBS in which BayernLB invested, Merrill Lynch entities acted as the “depositor” and “sponsor” of the securitization.

22. The depositor then securitizes the pool of loans in the issuing trust so that the rights to the cash flows from the pool can be sold to investors. The securitization transactions are structured such that the risk of loss is divided among different levels of investment, or “tranches,” with each having a different level of risk and reward. Typically, losses on the underlying loans—whether due to default, delinquency, or otherwise—are generally applied in reverse order of seniority. As such, senior tranches of pass-through securities are rated by credit rating agencies as investment grade, which denotes that the securities are prudent investments and of sound credit quality. All of the Merrill Lynch RMBS purchased by BayernLB were senior, risk-averse tranches of the relevant offerings and were all rated investment grade at issuance and when purchased by BayernLB.

23. Once the tranches are established, the issuing trust passes the securities back to the depositor, which becomes the issuer of the RMBS. The depositor then passes the RMBS to the underwriter—which offers and sells the securities to investors in exchange for cash that is passed back to the depositor, less any fees collected by the underwriter for underwriting the securitization. Typically, underwriters like Merrill Lynch, Pierce, Fenner & Smith Inc. would collect between 0.2% to 1.5% in discounts, concessions or commissions in serving as an underwriter of an RMBS securitization. Through Merrill Lynch entities serving as a sponsor and depositor of the securitizations, Merrill Lynch earned even more.

24. Merrill Lynch entities were involved in almost every step of the process of selling most of the Merrill Lynch RMBS to BayernLB. Merrill Lynch Mortgage Lending, Inc., which served as the sponsor for eight of the Merrill Lynch RMBS purchased by BayernLB, provided warehouse financing to the originators that issued the mortgage loans, acquired the mortgage loans from the originators, and initiated the securitization of the mortgage loans into RMBS by transferring the loans to Merrill Lynch Mortgage Investors, Inc., the depositor. The depositor, controlled by Merrill Lynch in most of the Merrill Lynch RMBS purchased by BayernLB, obtained the mortgage loans from the relevant sponsor to place into the issuing trust for sale in privately negotiated transactions. Importantly, Merrill Lynch provided the information that BayernLB used to decide whether to purchase the securities.

25. Because the cash flow from the loans in the collateral pool of a securitization is the source of funds to pay the holders of the RMBS issued by the trust, the credit quality of those securities depends upon the credit quality of the loans in the collateral pool. The most important information about the credit quality of the loans is contained in the “loan files” that the mortgage originator develops while making the loans. For residential mortgage loans, each loan file normally contains documents including: the borrower’s application for the loan; verification of the borrower’s income, assets, and employment; references; credit reports on the borrower; and an appraisal of the property that will secure the loan and provide the basis for important measures of credit quality, such as loan-to-value ratios.

26. The collateral pool of loans for each securitization usually includes thousands of loans. Instead of each potential investor reviewing thousands of loan files, Merrill Lynch, in its role as a sponsor and underwriter of the securitization, is responsible for gathering, verifying and presenting to potential investors accurate and complete information about the credit quality and characteristics of the loans that are deposited into the trust. Indeed, the most important

factors for BayernLB—and, for any investor—in purchasing Merrill Lynch RMBS were: (1) the ability of the underlying borrowers to repay their mortgages; (2) the ability for the trust to recover its losses in case of default by ensuring the properties were appropriate collateral for the loans and were accurately valued; and (3) the rate of interest received on the RMBS. The loan files themselves were not provided or available to RMBS investors, who instead relied wholly upon Merrill Lynch’s representations about the mortgages underlying the RMBS and the process used to select and review those loans.

27. As noted, all of the Merrill Lynch RMBS purchased by BayernLB were rated investment grade at issuance, as set forth below:

#	Offering & Tranche	CUSIP	Original Expenditure	Top Originators	Initial			Current		
					Moody's	Fitch	S&P	Moody's	Fitch	S&P
1	ARSI 2006-M1 A2D	04012MAA7	\$10,000,000	Amerquest Mortgage Co. Argent Mortgage Co., LLC	Aaa	AAA	AAA	Ca	C	CCC
2	ARSI 2006-M1 M1	04012MAB5	\$10,000,000	Amerquest Mortgage Co. Argent Mortgage Co., LLC	Aa1	AA+	AA+	WR	D	D
3	CBASS 2006-CB4 AV3	12498QAC0	\$8,000,000	Amerquest Mortgage Co. Encore Credit Corp. First NLC Ownit Mortgage Solutions, Inc.	Aaa	AAA	AAA	Caa3	CC	CCC
4	CBASS 2006-CB4 AV4	12498QAD8	\$11,000,000	Amerquest Mortgage Co. Encore Credit Corp. First NLC Ownit Mortgage Solutions, Inc.	Aaa	AAA	AAA	Ca	C	CCC
5	FFMER 2007-1 A2C	59023LAD4	\$60,000,000	First Franklin Financial Corp.	Aaa	NR	AAA	Ca	NR	CCC
6	FFML 2007-FFC A2B	32029HAC6	\$35,000,000	First Franklin Financial Corp.	Aaa	NR	AAA	C	NR	CC
7	LBMLT 2006-5 2A3	54251PAD9	\$20,000,000	Long Beach Mortgage Co.	Aaa	NR	AAA	Ca	NR	CCC
8	LBMLT 2006-5 2A4	54251PAE7	\$8,000,000	Long Beach Mortgage Co.	Aaa	NR	AAA	Ca	NR	CCC
9	MLMI 2006-AHL1 A2C	590210AD2	\$42,082,000	Accredited Home Lenders, Inc.	Aaa	NR	AAA	Ca	NR	CCC
10	MLMI 2006-FM1 M1	59021AAE8	\$12,250,000	Fremont Investment & Loan	Aa1	NR	AA+	C	NR	CC
11	MLMI 2006-HE3 A4	590212AD8	\$13,100,000	First NLC Lenders Direct Capital Corp. Lime Financial	Aaa	NR	AAA	Ca	NR	CCC

#	Offering & Tranche	CUSIP	Original Expenditure	Top Originators	Initial			Current		
					Moody's	Fitch	S&P	Moody's	Fitch	S&P
12	MLMI 2006-HE3 M1	590212AE6	\$20,990,000	First NLC Lenders Direct Capital Corp. Lime Financial	Aa1	NR	AA+	C	NR	D
13	NAA 2006-AF2 5A2	65536XAP8	\$18,513,000	Alliance Bancorp	Aaa	NR	AAA	C	NR	D
14	OWNIT 2006-5 A2D	69121EAF5	\$6,343,000	Ownit Mortgage Solutions, Inc.	Aaa	NR	AAA	Ca	NR	CCC
15	OWNIT 2006-5 M1	69121EAG3	\$8,249,000	Ownit Mortgage Solutions, Inc.	Aa1	NR	AA+	C	NR	D
16	OWNIT 2006-7 M1	69121UAF9	\$9,500,000	Ownit Mortgage Solutions, Inc.	Aa1	NR	AA+	WR	NR	D
17	RAAC 2006-SP2 A2	74919PAB5	\$15,000,000	Residential Funding Corp.	Aaa	AAA	AAA	Ba1	BB	AA-
18	SURF 2006-BC4 M1	84751YAF7	\$16,200,000	Specialty Underwriting & Residential Finance	Aa1	NR	AA+	C	NR	CC

## **B. Merrill Lynch's Activities In The Subprime Mortgage Arena**

28. Merrill Lynch's activities as a buyer, financier and securitizer of residential mortgage loans have been the focus of numerous government investigations and prosecutions as well as private investor lawsuits. Merrill Lynch's activities were integral to the growth and proliferation of high-risk mortgages that contributed to the financial crisis. Mortgage originators generated profits primarily through the sale of their loans to investment banks like Merrill Lynch, and the originators were therefore driven to originate and sell as many loans as possible. Increased demand for mortgages by banks like Merrill Lynch (which were competing to sell mortgage-backed products) led to increased volume in mortgage originations. That increased volume, in turn, led to a decrease in the gain-on-sale margins that mortgage originators received from selling pools of loans. As a result, originators began to borrow money from the same large banks that were buying their mortgages in order to fund the origination of even more mortgages.

29. One of the principal ways originators obtained such capital was by establishing a warehouse line of credit with an investment bank such as Merrill Lynch. The line of credit, in

turn, would be secured by the very mortgage loans that investment banks like Merrill Lynch would purchase for securitization. Merrill Lynch earned fees and interest income on those warehouse lines of credit.

**C. Merrill Lynch's Role Was To Ensure The Quality Of The Loans Backing The RMBS**

30. Merrill Lynch and the mortgage originators utilized two methods to securitize mortgages into RMBS for sale to investors. Specifically, the originators aggregated the loans into pools and would either (1) deposit them into a trust that would issue RMBS backed by the loans (referred to herein as an "originator securitization"), or (2) sell the loan pools to an investment bank, and the investment bank would then deposit the securities into a trust that would issue securities backed by the loans ("principal securitization"). Under the first approach, Merrill Lynch profited by the fees it received by serving as an underwriter of the securities issued by the originator. Under the second approach, because the investment bank is securitizing the loans on its own behalf, Merrill Lynch profited off of the difference in the price it paid for the loan pools it purchased from the originator and that which it received from the sale of those loans as RMBS.

31. Eight of the 13 Merrill Lynch RMBS purchased by BayernLB at issue in this action were securitized through principal securitization, whereby Merrill Lynch entities would first purchase loan pools originated by third-party originators and/or loan sellers and then sell those loans into the RMBS trust as the sponsor of a mortgage securitization. The involvement of a sophisticated investment bank such as Merrill Lynch throughout the securitization process indicates a higher degree of oversight and due diligence on the mortgages being selected for inclusion in the RMBS.

32. Indeed, Merrill Lynch routinely used outside third-party due diligence providers such as Clayton Holdings, Inc. (“Clayton”), to perform due diligence on the pools of mortgages that Merrill Lynch would securitize. For example, the prospectus supplements for the principal securitizations at issue here stated that “[p]rior to acquiring any residential mortgage loans, [Merrill Lynch Mortgage Lending, Inc.] conducts a review of the related mortgage loan seller that is based upon the credit quality of the selling institution,” which may include “reviewing select financial information for credit and risk assessment and conducting an underwriting guideline review, senior level management discussion and/or background checks.” According to the prospectus supplements, “[t]he scope of the mortgage loan due diligence varies based on the credit quality of the mortgage loans.” With regard to the underwriting guideline review, Merrill Lynch stated that:

The underwriting guideline review entails a review of the mortgage loan origination processes and systems. In addition, such review may involve a consideration of corporate policy and procedures relating to state and federal predatory lending, origination practices by jurisdiction, historical loan level loss experience, quality control practices, significant litigation and/or material investors.

33. Specifically, before purchasing loans from an originator, Merrill Lynch would perform due diligence on the mortgage loan pools by examining three areas—credit, compliance and valuation. First, credit diligence examined a sampling of the individual loans in a given loan pool to assess their quality and compliance with the underwriting guidelines of the originator. An originator’s underwriting guidelines are a critical tool for investors to evaluate the risk of default on the loans that serve as collateral for RMBS. Prudent lending standards—as articulated in an originator’s underwriting guidelines—are addressed in numerous federal guidance statements requiring that federally-regulated institutions adopt well-defined underwriting parameters such as acceptable loan-to-value ratios, debt-to-income ratios, and

minimum acceptable credit scores.<sup>1</sup> Those federal standards have been adopted by the subprime industry as a whole through substantially similar guidance published by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. These standards are intended not only to protect borrowers to ensure that they can repay their loans, but also to ensure the safety and soundness of individual lending institutions and the financial system as a whole. Second, compliance diligence focused on whether the loans were originated in compliance with state, federal and local laws, including predatory lending and truth-in-lending statutes. Third, valuation diligence checked the accuracy of the originator's reported property valuations of the collateral backing the loans. This due diligence provides comfort to investors that Merrill Lynch has ensured that only mortgages that conform to the originators' underwriting standards are being securitized.

34. In truth, Merrill Lynch routinely ignored the pervasive defects that its due diligence identified in the loans backing its RMBS. Merrill Lynch deliberately concealed these defects from BayernLB and other investors in order to increase its own profits, preserve its ongoing business relationships with the RMBS originators, and move risk from its own balance sheet onto investors.

#### **D. Factors Impacting The Quality Of The Merrill Lynch RMBS**

35. Federal regulators have long recognized the importance of sound lending and have for years issued guidance on subprime mortgage products to ensure that borrowers are able to repay their loans. For example, the 1993 Interagency Guidelines for Real Estate Lending, issued jointly by the Board of Governors of the Federal Reserve System (Merrill Lynch's

---

<sup>1</sup> See, e.g., 12 C.F.R. Part 34, subpart D (Office of the Comptroller of Currency standards); 12 C.F.R. Part 208, subpart C (Board of Governors of the Federal Reserve standards); 12 C.F.R. Part 365 (Federal Deposit Insurance Corporation standards); 12 C.F.R. 560.100 and 12 C.F.R. 560.101 (Office of Thrift Supervision standards); and 12 CFR 701.21 (National Credit Union Administration standards).

primary federal regulator), the Office of the Comptroller of the Treasury, the Federal Depository Insurance Commission, the Office of Thrift Supervision, and the National Credit Union Administration, provided that prudently underwritten real estate loans (subprime or otherwise) “should reflect all relevant credit factors, including . . . the capacity of the borrower, or income from the underlying property, to adequately service the debt.” Federal regulators responded to the growth of newer subprime products with enhanced guidance in 1999, warning that if risks associated with subprime lending were “not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound.”

36. The 1999 guidance recognized the critical role that banks such as Merrill Lynch, which comprised the primary market for the sale of subprime loans, played in dictating and enforcing underwriting standards for subprime mortgage lending:

Institutions should not accept loans from originators that do not meet their underwriting criteria, and should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio’s actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution’s criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or make adjustments to underwriting and dealer/lender selection criteria.

37. The guidance also required that “institutions . . . perform an ongoing analysis of subprime loans,” “have information systems in place to segment and stratify their portfolio (*e.g.*, by originator, loan-to-value, debt-to-income ratios, credit scores) and produce reports for management to evaluate the performance of subprime loans,” determine “whether performance meets expectations,” and “consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan administration procedures to restore performance to acceptable levels.”



38. Indeed, the fundamental basis upon which RMBS are valued is the ability of the borrowers to repay the principal and interest on the underlying loans and the adequacy of the collateral. Thus, proper loan underwriting is critical to assessing the borrowers' ability to repay the loans, and a necessary consideration when purchasing and pooling loans. If the loans pooled in the RMBS suffer defaults and delinquencies in excess of the assumptions built into the certificate payment structure, RMBS investors suffer losses because of the diminished cash flow into the RMBS.

39. Likewise, independent and accurate appraisals of the collateralized real estate are essential to ensure that the mortgage or home equity loan can be satisfied in the event of a default and foreclosure on a particular property. An accurate appraisal is necessary to determine the likely price at which the foreclosed property can be sold and, thus, the amount of money available to pass through to certificate holders.

40. An accurate appraisal is also critical to calculating the loan-to-value ("LTV") ratio, which is a financial metric commonly used to evaluate the price and risk of RMBS. The LTV ratio expresses the amount of mortgage or loan as a percentage of the appraised value of the collateral property. For example, if a borrower seeks to borrow \$90,000 to purchase a home worth \$100,000, the LTV ratio is equal to \$90,000 divided by \$100,000, or 90%. If, however, the appraised value of the house has been artificially inflated to \$100,000 from \$90,000, the real LTV ratio would be 100% (\$90,000 divided by \$90,000). The term combined loan-to-value ratio ("CLTV") applies to the situation in which more than one loan is secured by a particular property. For example, a property valued at \$100,000 with a single mortgage of \$50,000 has an LTV of 50%. A similar property with a value of \$100,000 with a first mortgage of \$50,000 and a second lien mortgage of \$25,000 has an aggregate mortgage balance of \$75,000, and a CLTV of 75%.

41. From an investor's perspective, a high LTV or CLTV ratio represents a greater risk of default on the loan. First, borrowers with a small equity position in the underlying property have "less to lose" in the event of a default. Second, even a slight drop in housing prices might cause a loan with a high LTV ratio to exceed the value of the underlying collateral, which might cause the borrower to default and would prevent the issuing trust from recouping its expected return in the case of foreclosure and subsequent sale of the property.

42. Consequently, the LTV ratios of the loans underlying the RMBS are important to investors' assessment of the value of such RMBS. Prospectuses typically provide information regarding the LTV ratios, and even guarantee certain LTV ratio limits for the loans that will support the RMBS. The representations in the Offering Materials regarding LTVs were false because a substantial portion of the loans backing the Merrill Lynch RMBS had LTVs far higher than represented as calculated under independent property valuations obtained by Merrill Lynch.

43. Another important metric when considering a borrower's ability to repay a loan is a borrower's debt-to-income ratio, or DTI, which reflects the increased risk that borrowers whose debt is relatively high compared to their income will default on their loans. While a borrower's current DTI is a good measure of his or her capacity to repay a fixed-rate mortgage, other loan products, such as adjustable rate mortgages ("ARMs"), have initial "teaser" rates that reset at much higher index rates after a certain period. A "fully indexed rate" accounts for this interest rate reset, and represents the interest rate over the life of the loan, calculated by adding the index rate at origination and the margin that a lender adds to the index rate after the initial "teaser" period. For example, if the current index rate is 2.5%, and if the margin on a particular loan is 3%, the fully indexed rate on that loan is 5.5%. Because the fully indexed rate accounts

for the current value of the interest rate index used by an ARM, it is a better measure of a borrower's ability to repay the loan.

44. In 2006, the interagency regulators, responding to the explosive growth of non-traditional mortgage products, provided revised guidance explicitly addressing how institutions should calculate a borrower's DTI. Specifically, the underwriting guidelines state that “[w]hen an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins.” Moreover, according to the guidance:

*For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.* In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.<sup>2</sup>

45. The federal guidance thus served to provide assurance to investors that investments in instruments backed by subprime mortgages could be safe and conservative products so long as the underlying loans were properly underwritten and scrutinized. Indeed, the federal guidance made clear that heightened attention to and rigorous compliance with strict underwriting standards was critical for institutions engaged in subprime lending due to the unique risks posed by that borrower population. As regulators made clear, in the context of RMBS such as those purchased by BayernLB here, representations concerning underwriting guidelines, appraisals, LTVs and DTIs were paramount.

---

<sup>2</sup> All emphasis added unless otherwise indicated.

V. **THE OFFERING MATERIALS MISREPRESENTED THE UNDERWRITING AND QUALITY OF THE LOANS BACKING THE MERRILL LYNCH RMBS**

46. Contrary to the statements in the Offering Materials and other communications by Merrill Lynch used to solicit BayernLB's investment in the Merrill Lynch RMBS, the originators whose loans served as collateral for the investments routinely and egregiously violated their stated underwriting guidelines. As a result, the mortgages they originated presented a materially higher risk to investors than represented by Merrill Lynch in the Offering Materials.

47. For example, the OWNIT 2006-5 prospectus supplement described Ownit Mortgage Solutions, Inc.'s ("Ownit") underwriting guidelines, in relevant part, as follows:

Ownit has been engaged in the business of originating non-conforming mortgage loans since 1994. Ownit is the originator of the "RightLoan", a proprietary loan product that focuses on purchase, owner occupied, full documentation loans.

\* \* \*

The Underwriting Guidelines and Credit Matrices of the RightLoan are designed to be used as a guide in determining the credit worthiness of the borrower and his/her ability to repay. The guidelines, a reasonable loan amount and the RightLoan itself offer a solution that also facilitates making logical exceptions to those guides. Exceptions to the guidelines will be made if the loan meets the primary criteria of the RightLoan and offers supported compensating factors when a deviation occurs. In all cases, the exception(s) and compensating factor(s) are clearly documented in the file and require branch manager approval and a second signature from the corporate underwriter.

Using the three components, capacity, credit and collateral, the underwriter analyzes the loan profile. Capacity, which is the borrower's ability to repay, is determined by cash flow. It must be clearly shown that the borrower has a proven, historical cash flow, which will support the requested loan amount. This approach anticipates that the loan is going to be repaid from the borrower's recurring cash inflows, not from the sale of the collateral. Job stability and length of time in current residence are also strong factors in determining a borrower's capacity. Continuity of employment is a strong factor in establishing the income used as a basis for repayment. Credit is the borrower's willingness to repay his or her debts according to the contractual agreements. The most

valuable resource in determining the borrower's ability to repay is the credit report. Ownit underwriters will use the credit report and credit explanation letter when supplied in determining willingness. Ownit uses the credit score as a primary factor in determining the borrower's willingness to repay his or her debts. Collateral is defined as the asset pledged by the borrower to the lender. Collateral is a secondary source of repayment; cash flow is the primary source of repayment. Ownit will evaluate the property by reviewing uniform residential real estate appraisal reports, along with other data sources, to determine whether the collateral is sufficient to secure the mortgage.

48. Further, like the other originators whose loans backed the Merrill Lynch RMBS purchased by BayernLB, the Offering Materials described the documentation that the originators purportedly required prospective borrowers to produce in order to properly obtain a mortgage loan. For example, the OWNIT 2006-5 prospectus supplement stated, in relevant part, as follows:

Capacity. Several aspects are considered in determining the borrower's capacity or ability to repay the loan. The key factors are employment documentation, history and amount of income used to derive the debt to income ratios. Ownit offers three income documentation options: Full documentation includes traditional employment verification such as pay stubs, W2s or/and tax returns. A copy of the borrower's personal or business bank statements for the most recent 12 month period also constitutes full income documentation. Limited Income Verification (LIV) represents an average of 6 months bank statement averages. No Income Verification (NIV) uses the income stated by the borrower on the 1003 loan application to qualify. Satisfactory employment history is established with 2 years at the same job or similar, related field. Verbal employment verification is performed prior to funding for all documentation types and good probability of continuance is required. The actual method of calculating and documenting employment history and income depends on the borrower's credit score and LTV. Higher LTVs and lower credit scores require a longer period in which income must be verified. Base debt to income ratios are set at 45% or 50% depending on credit score, LTV, documentation type and if the borrower is a first time home buyer. In some cases the maximum debt ratio may increase to 55% based on meeting a minimum disposable income requirement.

Credit. A satisfactory credit history is the most reliable criterion in

determining a borrower's credit worthiness. Ownit relies on the scoring models developed by the national credit bureaus: Experian, Transunion and Equifax for much of that decision process.

49. The Offering Materials also provided information regarding the appraisal standards and practices employed by the Merrill Lynch RMBS originators. For example, the OWNIT 2006-5 prospectus supplement described Ownit's appraisal practices as follows:

Collateral. The collateral value and amount of equity in the subject property are important factors in assessing the risk of a particular loan. All properties must conform to the neighborhood and be in average or better condition. Acceptable property type includes: 1-2 family, 3-4 family, condominiums, planned unit developments (PUDs), modular homes and leasehold properties. Emphasis is placed on property type, location and occupancy to determine risk associated with specific LTV and credit score. Maximum financing is not available for rural properties, neighborhoods with declining values, oversupply of housing and/or marketing time over 6 months, or properties at the low or high end of value range with no comparable sales in the immediate area. Maximum financing is also not available on transactions involving a gift of equity. All appraisals should conform to the Uniform Standards of Professional Appraisal Practices. Ownit requires the underwriter to review all appraisals for content and accuracy, pulling additional data if available or warranted. Certain types of transactions require an enhanced desk or field review. Loan amounts in excess of \$650,000 require a second full appraisal. The minimum square footage is 700 and deferred maintenance must be cosmetic in nature, not resulting in a health or safety hazard and should not exceed \$3,500 cost to cure.

50. The Offering Materials also incorporated the investment grade ratings assigned to the Merrill Lynch RMBS purchased by BayernLB. For example, the OWNIT 2006-5 prospectus supplement represented as follows:

It is a condition of the issuance of the Offered Certificates that they be assigned the ratings designated below by Moody's and S&P.

CLASS OF CERTIFICATES	MOODY'S	S&P
A-1A.....	Aaa	AAA
A-1B.....	Aaa	AAA
A-2A.....	Aaa	AAA
A-2B.....	Aaa	AAA
A-2C.....	Aaa	AAA
A-2D.....	Aaa	AAA
M-1.....	Aa1	AA+
M-2.....	Aa2	AA+
M-3.....	Aa3	AA+
M-4.....	A1	AA+
M-5.....	A2	AA
M-6.....	A3	AA
B-1.....	Baa1	AA-
B-2.....	Baa2	A+
B-3.....	Baa3	A
R.....	NR	AAA

The security ratings assigned to the Offered Certificates should be evaluated independently from similar ratings on other types of securities. A security rating is not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the Rating Agencies. The ratings on the Offered Certificates do not, however, constitute statements regarding the likelihood or frequency of prepayments on the Mortgage Loans, the payment of the Floating Rate Certificate Carryover or the anticipated yields in light of prepayments.

The ratings of Moody's on mortgage pass-through certificates address the likelihood of the receipt by certificateholders of all distributions to which such certificateholders are entitled. Moody's ratings opinions address the structural and legal issues associated with the Offered Certificates, including the nature of the underlying Mortgage Loans. Moody's ratings on pass-through certificates do not represent any assessment of the likelihood that principal prepayments may differ from those originally anticipated nor do they address the possibility that, as a result of principal prepayments, certificateholders may receive a lower than anticipated yield.

S&P's ratings on mortgage pass-through certificates address the likelihood of receipt by certificateholders of payments required under the operative agreements. S&P's ratings take into consideration the credit quality of the mortgage pool including any credit support providers, structural and legal aspects associated with the certificates, and the extent to which the payment stream of the mortgage pool is adequate to make payments required under the certificates. S&P's ratings on mortgage pass-through certificates do not, however, constitute a statement regarding the

frequency of prepayments on the mortgage loans or address the likelihood of receipt of Floating Rate Certificate Carryover. S&P's ratings do not address the possibility that investors may suffer a lower than anticipated yield.

51. These statements of material fact, and materially similar statements appearing in the Merrill Lynch RMBS Offering Materials, were false and misleading when made because the originators whose loans backed the Merrill Lynch RMBS purchased by BayernLB failed to adhere to their established underwriting standards and Merrill Lynch concealed from investors the results of its third-party due diligence reports. Indeed, the reckless practices of the mortgage originators whose loans backed the Merrill Lynch RMBS rendered numerous statements concerning the originators' guidelines, the LTV and DTI ratios, property appraisal values, the credit ratings assigned to the RMBS, the due diligence Merrill Lynch conducted on the mortgage originators, and the true risks of the RMBS materially false and misleading. As such, the riskiness of the loans underlying the RMBS purchased by BayernLB, and thus the true risk profile of the RMBS was materially misrepresented. Through Merrill Lynch's due diligence process, as well as its intimate knowledge of the originators' underwriting practices gleaned through its warehouse lending relationships, Merrill Lynch knew of these violations, and concealed them from BayernLB.

**VI. MERRILL LYNCH KNEW THE TRUTH ABOUT THE ORIGINATORS' LENDING PRACTICES AND THE FALSITY OF THE CREDIT RATINGS ASSIGNED TO ITS RMBS**

52. Merrill Lynch scrutinized the loans and identified the rampant underwriting deficiencies at the mortgage originators identified above. Notwithstanding its knowledge about the true risks of default those loans presented, it sold them as RMBS to BayernLB.

53. Among other things, Merrill Lynch learned through its due diligence process that a substantial portion of the loans backing its RMBS woefully failed to meet the underwriting standards of those originators. In fact, Merrill Lynch's due diligence process identified a



pattern establishing that the loans Merrill Lynch purchased for securitization failed to meet the originators' underwriting guidelines, had other deficiencies, violated state and federal law, and/or were based on inflated property valuations.

54. As described in transcripts of interviews conducted by the U.S. Government Financial Crisis Inquiry Commission ("FCIC"), Merrill Lynch selected Clayton to serve as its third-party due diligence provider and rejected Clayton's credit due diligence findings as a matter of course. During its review, Clayton would assign each loan a number—1, 2 or 3—to reflect Clayton's evaluation of the soundness of the loan. The numbering referred to three different levels, "1" being the best—*i.e.*, the loan met the originators' underwriting guidelines—and a "3" being the worst, indicating that the loan failed to meet the originators' underwriting guidelines and lacked sufficient compensating factors.

55. As reflected through documents Clayton produced to the FCIC, almost one-fourth of the Merrill Lynch-securitized loans sampled by Clayton during the height of the mortgage boom (from 2006 to mid-2007) were defectively originated and received grades of "3." Moreover, a Clayton report reveals that, over this same period, Merrill Lynch overruled Clayton's findings *and "waived" almost one-third of all such defective "exception" loans* and securitized them into RMBS that were sold to investors like BayernLB.

56. Extrapolating the results of Merrill Lynch's "waive in" rate of the loans Clayton had rejected for failing to meet originators' guidelines to the entire loan pools backing the Merrill Lynch RMBS purchased by BayernLB reveals the extent to which Merrill Lynch *knew* the loans it had securitized were destined to fail. As the FCIC Report concluded with regard to the Offering Materials for RMBS:

[M]any prospectuses indicated that the loans in the pool either met guidelines outright or had compensating factors, even though Clayton's records show that only a portion of the loans were

sampled, and that of those that were sampled, a substantial percentage of Grade 3 loans were waived in....[O]ne could reasonably expect [the untested loans] to have many of the same deficiencies, at the same rate, as the sampled loans. *Prospectuses for the ultimate investors in the mortgage-backed securities did not contain this information, or information on how few of the loans were reviewed, raising the question of whether the disclosures were materially misleading, in violation of the securities laws.*

FCIC Report at 167, 170.

57. Merrill Lynch’s astounding “waive in” rate and the implications for the quality of the RMBS underwritten by Merrill Lynch, Pierce, Fenner & Smith Inc. rendered materially false and misleading numerous statements in the Offering Materials relied on by BayernLB in purchasing the Merrill Lynch RMBS. Merrill Lynch’s waiver rate also illustrates Merrill Lynch’s knowledge of the systemic underwriting violations of the loans backing its RMBS that led to massive delinquencies and defaults, and which caused substantial losses to BayernLB.

58. Merrill Lynch also knew that the ratings assigned to its RMBS were not reliable because those ratings were bought and paid for, and were supported by false information regarding the originators’ underwriting guidelines that Merrill Lynch provided, among other things. To bring its RMBS to market, Merrill Lynch knew that it needed to obtain the highest “investment grade” ratings possible from the credit rating agencies (“CRAs”)—Moody’s, S&P, and Fitch—that rated Merrill Lynch’s securitizations at issue here. Indeed, Merrill Lynch featured the ratings prominently in the Offering Materials and discussed at length the ratings received by the different tranches of the RMBS, and the bases for the ratings.

59. “Investment grade” products are understood in the marketplace to be stable, secure and safe. Any instrument rated below BBB is considered below investment grade or a “junk bond.”

60. The Offering Materials for the Merrill Lynch RMBS that BayernLB purchased state that the issuance of each tranche of the RMBS was conditioned on the assignment of particular ratings, and listed the ratings in a chart. The Offering Materials also state that the ratings address the likelihood of the receipt by a certificateholder of distributions on the mortgage loans to which they are entitled, and that the ratings take into consideration the characteristics of the mortgage loans. All of the RMBS purchased by BayernLB were investment grade rated tranches. The investment grade rating denotes that the RMBS were prudent investments and of sound credit quality.

61. The above statements (and the substantially similar statements appearing in all of the Merrill Lynch RMBS Offering Materials) regarding the ratings assigned to the Merrill Lynch RMBS, as well as the ratings themselves, were materially false and misleading because Merrill Lynch touted these ratings while knowing that the ratings were based on the misleading information Merrill Lynch provided to the CRAs, and on Merrill Lynch's manipulation of the rating process.

62. The credit ratings of the Merrill Lynch RMBS were further compromised by misinformation provided by Merrill Lynch regarding the abandonment of the originators' underwriting standards, rampant use of aggressive exceptions, and the inflated appraisals assigned to the underlying collateral, among other things. Defendants knew that the investment grade ratings assigned to the RMBS were false because the originators did not follow their own underwriting standards and, as such, no reliable estimate could be made concerning the level of enhancement necessary to ensure that the tranches purchased by BayernLB were worthy of an investment grade rating. By including and endorsing these ratings in the Offering Materials, Merrill Lynch was making a false representation that it actually believed that the ratings were an accurate reflection of the credit quality of the RMBS.

63. Subsequent downgrades confirm that the investment grade ratings reported in the Offering Materials were unjustifiably high and misstated the true credit risk of the RMBS purchased by BayernLB. The RMBS purchased by BayernLB—all of which were each initially rated investment grade—have all been downgraded to junk by at least one credit rating agency. The *en masse* downgrade of investment grade rated RMBS indicates that the ratings set forth in the Offering Materials were false, unreliable and inflated.

**VII. DEFENDANTS' FALSE AND MISLEADING MISSTATEMENTS AND OMISSIONS OF MATERIAL FACT IN THE OFFERING DOCUMENTS**

64. The Offering Materials BayernLB relied upon in purchasing the Merrill Lynch RMBS contained numerous misrepresentations of material fact, or omitted to state material facts necessary to make the statements therein not misleading, regarding: (i) the originators' underwriting practices and guidelines by which the loans were originated, including the prevalence and type of exceptions to those guidelines being applied to the underlying loans, and the rampant fraud in stated income loans; (ii) the value of the underlying property securing the loans, in terms of LTV and CLTV ratios and the appraisal standards by which such mortgaged properties were measured; (iii) the due diligence that Merrill Lynch conducted into the lenders whose mortgage loans back the RMBS; (iv) the credit ratings assigned to the RMBS; and (v) the true risks of the RMBS.

65. The statements of material fact regarding the originators whose loans back the Merrill Lynch RMBS in which BayernLB invested were materially false and misleading when made because they misrepresented the true facts, known by Merrill Lynch, that the originators: (i) systematically and flagrantly failed to follow their stated underwriting guidelines; (ii) allowed pervasive exceptions to their underwriting standards regardless of existing compensating factors; (iii) disregarded credit quality to fuel loan originations to sell to loan purchasers such as Merrill

Lynch; and (iv) routinely allowed fraudulent representations of an applicant's stated income, failed to verify a prospective borrowers documentation or statements regarding income or assets, and, in many cases, knowingly falsified the borrower's stated or documented income or assets.

66. The representations regarding the due diligence that Merrill Lynch conducted into the mortgage lenders that issued the loans backing the RMBS and the quality of those loans were materially false and misleading because (i) Merrill Lynch routinely ignored the pervasive defects that its internal and external due diligence processes identified in the loans that backed its RMBS; and (ii) Merrill Lynch routinely overruled the determinations of its due diligence providers and waived into its securitizations defective mortgage loans.

67. The representations regarding appraisals and LTV ratios were materially false and misleading in that they misrepresented the appraisal process employed by the originators, including, among others things, the fact that: (i) the appraisers were not independent from the respective mortgage lenders, which pressured appraisers to value the mortgaged property at a pre-determined, preconceived, inflated, and false appraisal value; (ii) the actual LTV ratios for many of the mortgage loans underlying the RMBS would have far exceeded the represented value if the mortgaged properties had been appraised by an independent appraiser as stated in the Offering Documents; (iii) sales managers employed by the respective originators had and utilized the authority to override and inflate an appraiser's final professional valuation of the mortgaged property; and, as such, (iv) the appraisals failed to conform to the standards set by Fannie Mae and Freddie Mac.

68. Further, Defendants represented in the Offering Materials that all of the RMBS purchased by BayernLB were worthy of being rated investment grade, signifying that the RMBS were prudent investments. By providing ratings, Defendants represented that they believed that the information provided to the rating agencies to support these ratings accurately reflected

Merrill Lynch's and the originators' underwriting guidelines and practices, and the specific qualities of the underlying loans.

69. These statements regarding the ratings assigned to the RMBS were false and misleading because Defendants stated the assigned ratings while knowing that misleading information was provided to the rating agencies to guarantee investment grade ratings were assigned to the RMBS.

70. Defendants' purported warnings in the Offering Materials were themselves materially false and misleading because they failed to convey the severity of the investment risk at the time of the offering because: (i) the stated underwriting standards and practices of the mortgage originators whose loans comprised the RMBS were completely disregarded by the mortgage lenders identified above, resulting in loans that presented extremely high risks of default; (ii) Merrill Lynch concealed that the due diligence it conducted on the mortgage loans that comprised the relevant RMBS revealed a substantial number of defective loans; (iii) Merrill Lynch materially misrepresented the originators' rampant use of exceptions in the absence of existing compensating factors in order to generate loan volume and profits; (iv) Merrill Lynch concealed that the loans backing its RMBS had LTV and CLTV ratios at a level at which the borrowers would be unable to repay; (v) Merrill Lynch failed to address the fact that the loans comprising its RMBS had DTI ratios at a level that evidenced borrowers' inability to repay; (vi) Merrill Lynch misrepresented that the loans underlying its RMBS were issued pursuant to inflated appraisals; (vii) Merrill Lynch misrepresented that the loans comprising the RMBS were issued to borrowers regardless of the borrowers' ability to repay the mortgage loan; and (viii) Merrill Lynch intentionally provided misleading information to the rating agencies to guarantee investment grade ratings were assigned to the RMBS, such that the initial ratings assigned to the

RMBS were false, unjustified, and did not represent the true likelihood of receipt by certificateholders of all distributions to which they were entitled.

71. By purporting to warn RMBS investors of matters that Merrill Lynch already knew, or recklessly disregarded, to exist at the time the RMBS were issued, Merrill Lynch misled BayernLB to believe that these risks were mere potentialities and not circumstances that already existed when the RMBS were issued.

#### **VIII. BAYERNLB'S INVESTMENT IN THE RMBS AND RELIANCE ON MERRILL LYNCH'S MISREPRESENTATIONS**

72. BayernLB relied on Defendants' false representations and omissions of material fact regarding the origination and underwriting standards used to create the loan pools and the characteristics of the mortgage loans underlying the RMBS. But for Defendants' fraudulent representations and omissions, BayernLB would not have purchased the RMBS.

73. BayernLB used detailed guidelines and criteria for making investment decisions regarding subprime, prime and Alt-A RMBS, including "product papers" issued by BayernLB's risk office and applied by BayernLB's personnel to determine whether RMBS were appropriate investment decisions. For example, the April 6, 2006 product paper for Subprime RMBS provided that BayernLB would "only invest in sub-prime MBS transactions securitized by experienced issuers with sound underwritten procedures," that RMBS were to have a minimum credit rating of at least AAA or AA by "at least two of the three rating agencies (Moody's, S&P and Fitch)," and that for AAA-rated RMBS the maximum effective LTV ratio was 85% (for AA-rated RMBS the maximum effective LTV was 82%, more strict than the level for AAA-rated RMBS) and the minimum FICO score was 600 (610 for AA-rated RMBS). BayernLB's April 6, 2006 subprime RMBS product paper also provided owner-occupancy guidelines, stating under the heading "collateral characteristics" that:

The mortgaged properties may be single family, multi-family, condo, co-op or Planned Unit Development (PUD). The residential status may be owner occupied, second home or investment properties. Historical data indicate that owner occupied property has the lowest probability of default, and single family property has the highest recovery ratio, all else being equal. Therefore, collateral with the highest owner occupied single family properties are preferred.

74. BayernLB performed similar analyses in reliance on information provided by Defendants in making investment decisions for all RMBS at issue and reasonably relied on Defendants' representations in the Offering Materials to implement applicable RMBS purchasing guidelines, and to make investment decisions for the RMBS at issue.

75. The prospectus supplements contained detailed descriptions of the mortgage pools underlying the RMBS. The respective prospectus supplements provided the specific terms of the particular RMBS offering. Each prospectus supplement included tabular data concerning the loans underlying the RMBS, including (but not limited to) the type of loans; the number of loans; the mortgage rate and net mortgage rate (the mortgage rate net of the premium for any lender paid mortgage insurance less the sum of the master servicing fee and the trustee fee on the mortgage loan); the aggregate scheduled principal balance of the loans; the weighted average original combined LTV ratio; occupancy rates; credit enhancement; and the geographic concentration of the mortgaged properties. The prospectus supplements also contained a summary of the originators' underwriting and appraisal standards, guidelines and practices. The registration statements incorporated by reference the subsequently filed prospectuses and prospectus supplements.

76. In deciding to purchase the RMBS, BayernLB relied on Defendants' false representations and omissions of material fact regarding their underwriting standards and the



characteristics of the mortgage loans underlying the RMBS. But for the Defendants' fraudulent representations and omissions, BayernLB would not have purchased the RMBS.

77. BayernLB reviewed and analyzed the information provided directly or indirectly by Defendants with respect to each offering of RMBS and performed various analyses of the RMBS-specific data for each offering before deciding to purchase the RMBS. The analyses conducted by BayernLB before deciding to purchase RMBS included various credit analyses based on the information provided by Defendants with respect to both the credit characteristics of the mortgage loan pool (including, for example, geographic concentration; weighted average life; fixed- or floating-rate loans; full-, low-, or no-documentation "stated income" loans; and owner-occupied, second home, or investment properties), and the structure of the securitization with respect to the seniority and risk characteristics of the particular tranche of RMBS (including, for example, position in the payment "waterfall").

78. Thus, BayernLB justifiably relied on the information in the term sheets, computational material, and other data provided directly or indirectly by Defendants for each offering of the RMBS. These documents contained numerous statements of material fact about the RMBS, including statements concerning: (i) the mortgage originators' underwriting guidelines that were purportedly applied to evaluate the ability of the borrowers to repay the loans underlying the RMBS; (ii) the appraisal guidelines that were purportedly applied to evaluate the value and adequacy of the mortgaged properties as collateral; (iii) the LTV ratios, debt to income ratios, and purported occupancy status of the mortgaged properties, including whether the properties were "owner occupied," "second homes," or "investment properties"; (iv) Defendants' due diligence of the loans and the originators' underwriting practices; (v) various forms of credit enhancement applicable to certain tranches of RMBS; and (vi) the ratings assigned to the RMBS.

79. These statements of material fact were untrue because: (i) the originators violated their stated underwriting guidelines and did not originate loans based on the borrowers' ability to repay; and (ii) inflated appraisals caused the listed LTV ratios and levels of credit enhancement to be untrue. In addition, metrics such as debt-to-income ratios were untrue as a result of the other mortgage originators' acceptance of untrue information from mortgage applicants. For example, the other mortgage originators allowed applicants for "stated income" loans to provide untrue income information and did not verify the applicants' purported income. In addition, the credit ratings on which BayernLB relied were materially misleading, did not reflect the true credit quality of the RMBS, and were the result of intentional manipulation.

**IX. BECAUSE OF DEFENDANTS' FRAUDULENT CONDUCT, BAYERNLB SUFFERED LOSSES ON THE RMBS BAYERNLB PURCHASED**

80. The ratings on all of the RMBS have since been severely downgraded and they are no longer marketable or salable at or near the prices paid for them by BayernLB. Because of Defendants' fraudulent conduct as described herein, the true value of the Merrill Lynch RMBS was worth far less than the prices BayernLB paid. All of the RMBS in which BayernLB purchased interests were rated investment grade at issuance and have since been downgraded to junk by at least one credit rating agency.

**FIRST CAUSE OF ACTION**

**(Common Law Fraud Against All Defendants)**

81. BayernLB repeats and realleges the allegations set forth in the preceding paragraphs, as if fully set forth herein.

82. As alleged above, in the Offering Materials, Defendants made fraudulent and false statements of material fact, and omitted material facts necessary in order to make their statements, in light of the circumstances under which the statements were made, not misleading.

83. As a corporate parent, Merrill Lynch & Co., Inc. directed the activities of the Merrill Lynch entities that served as underwriter, sponsor and depositor for the securitizations at issue here.

84. Defendants knew at the time they sold and marketed each of the RMBS that the foregoing statements were false or, at the very least, made recklessly, without any belief in the truth of the statements.

85. Defendants made these materially false and misleading statements and omissions for the purpose of inducing BayernLB to purchase the RMBS. Furthermore, these statements related to these Defendants' own acts and omissions.

86. Defendants knew or recklessly disregarded that investors were relying on their expertise, and they encouraged such reliance through the Offering Materials and their public representations, as described herein. Defendants knew or recklessly disregarded that investors would rely upon their representations in connection their decision to purchase the RMBS. Defendants were in a position of unique and superior knowledge regarding the true facts concerning the foregoing material misrepresentations and omissions.

87. It was only by making such representations that Defendants were able to induce BayernLB to buy the RMBS. BayernLB would not have purchased or otherwise acquired the RMBS but for Defendants' fraudulent representations and omissions about the quality of the RMBS.

88. BayernLB justifiably, reasonably and foreseeably relied upon Defendants' representations and false statements regarding the quality of the RMBS.

89. As a result of the false and misleading statements and omissions, as alleged herein, BayernLB purchased Certificates that were worth far less than what it paid for them at the time of purchase, and BayernLB has suffered substantial damages as a result.

## **SECOND CAUSE OF ACTION**

### **(Fraudulent Inducement Against All Defendants)**

90. BayernLB repeats and realleges the allegations set forth in the preceding paragraphs, as if fully set forth herein.

91. As alleged above, in the Offering Materials and in other communications to BayernLB, Defendants made fraudulent and false statements of material fact, and omitted material facts necessary in order to make their statements, in light of the circumstances under which the statements were made, not misleading.

92. As a corporate parent, Merrill Lynch & Co., Inc. directed the activities of the Merrill Lynch entities that served as underwriter, sponsor and depositor for the securitizations at issue here.

93. Defendants knew at the time they sold and marketed each of the RMBS that the foregoing statements were false or, at the very least, made recklessly, without any belief in the truth of the statements.

94. Defendants made these materially misleading statements and omissions for the purpose of inducing BayernLB to purchase the RMBS. Furthermore, these statements related to these Defendants' own acts and omissions.

95. Defendants knew or recklessly disregarded that investors were relying on their expertise, and they encouraged such reliance through the Offering Materials and their public representations, as described herein. Defendants knew or recklessly disregarded that investors would rely upon their representations in connection with their decision to purchase the RMBS. Defendants were in a position of unique and superior knowledge regarding the true facts concerning the foregoing material misrepresentations and omissions.

96. It was only by making such representations that Defendants were able to induce BayernLB to buy the RMBS. BayernLB would not have purchased or otherwise acquired the RMBS but for Defendants' fraudulent representations and omissions about the quality of the RMBS.

97. BayernLB justifiably, reasonably and foreseeably relied upon Defendants' representations and false statements regarding the quality of the RMBS.

98. By virtue of Defendants' false and misleading statements and omissions, as alleged herein, BayernLB purchased Certificates that were worth far less than what it paid for them at the time of purchase, and BayernLB has suffered substantial damages as a result and is entitled to rescissory damages.

### **THIRD CAUSE OF ACTION**

#### **(Aiding And Abetting Fraud Against All Defendants)**

99. BayernLB repeats and realleges the allegations set forth in the preceding paragraphs, as if fully set forth herein.

100. This is a claim against Defendants for aiding and abetting the fraud committed by, between and among each of the other Defendants. Each of these Defendants aided and abetted the fraud committed by and among all of the other Defendants.

101. Defendants knew of the fraud perpetrated by them on BayernLB. As alleged above, each of the Defendants knew that the RMBS were not backed by high quality loans and were not underwritten according to the originators' underwriting standards, knew that due diligence was conducted on the loan pools securitized into the Merrill Lynch RMBS purchased by BayernLB that identified the originators' deviations from loan underwriting and appraisal standards, and participated in those violations and had actual knowledge of their own acts, or

participated in or had actual knowledge of Defendants' reckless or intentional dissemination of false and misleading information to the CRAs.

102. Furthermore, Defendants provided to each other substantial assistance in advancing the commission of the fraud. As alleged above, each Defendant participated in the violations of concealing the originators' deviations from their stated mortgage loan underwriting and appraisal standards, made false statements about the originators' mortgage loan underwriting and appraisal standards and Merrill Lynch's own underwriting guidelines, provided false information about the mortgage loans underlying the Certificates to the credit rating agencies, or provided false information for use in the Offering Materials.

103. It was foreseeable to Defendants at the time they actively assisted in the commission of the fraud that BayernLB would be harmed as a result of their assistance.

104. As a direct and natural result of the fraud committed by Defendants and each of the Defendants' knowing and active participation therein, BayernLB purchased Certificates that were worth far less than what it paid for them at the time of purchase, and BayernLB has suffered substantial damages as a result.

#### **FOURTH CAUSE OF ACTION**

##### **(Negligent Misrepresentation Against All Defendants)**

105. BayernLB repeats and realleges each and every allegation set forth in the preceding paragraphs above as if fully set forth herein, except any allegations that Defendants made any untrue statements and omissions intentionally or recklessly. For the purposes of this Count, BayernLB expressly disclaims any claim of fraud, reckless, or intentional misconduct.

106. This is a claim for negligent misrepresentation against Defendants. As a corporate parent, Merrill Lynch & Co., Inc. directed the activities of the Merrill Lynch entities that served as underwriter, sponsor and depositor for the securitizations at issue here.

107. It is commonly accepted industry practice for underwriters of RMBS to perform due diligence on the loans backing the RMBS to ensure that the quality of the loans are as represented in the offering materials provided to investors. Moreover, Defendants represented that they conducted due diligence on the mortgage originators that issued the loans for the RMBS that BayernLB purchased.

108. The purpose and effect of the representations that Defendants performed due diligence, and the understanding that RMBS underwriters generally perform such due diligence, was to assure BayernLB that it could reasonably rely upon the Offering Materials. Moreover, by virtue of the due diligence Defendants performed, and Defendants' extensive role in originating, purchasing, securitizing and selling the RMBS that BayernLB purchased, Defendants had unique and special knowledge and expertise regarding the loans backing those securities, including their quality, the nature of the underwriting, and the value of the collateral.

109. In particular, because BayernLB neither had the same level of information regarding the mortgage lenders for the loans backing the RMBS, nor had access to the loan files for such loans, and because BayernLB could not examine the underwriting quality of the mortgage loans in the securitizations on a loan-by-loan basis, BayernLB was heavily dependent on Defendants' unique and special knowledge regarding the underwriting standards of the relevant mortgage originators and the underlying loans when determining whether to invest in each RMBS. BayernLB was entirely dependent on Defendants to provide accurate information regarding the underwriting standards for the loans and the quality of those loans in engaging in their analysis. Accordingly, Defendants were uniquely situated to evaluate the economics of each RMBS.

110. Because BayernLB was without access to critical information regarding the underwriting standards of the mortgage originators for the Merrill Lynch RMBS and Merrill

Lynch represented that it would perform due diligence on such lenders, coupled with the industry understanding that RMBS underwriters perform due diligence, Merrill Lynch had a duty to BayernLB to verify the accuracy of the Offering Materials.

111. Over the course of approximately two years and 18 separate investments, BayernLB relied on Defendants' unique and special knowledge regarding the quality of the underlying mortgage loans and their underwriting when determining whether to invest in the RMBS. This longstanding relationship, coupled with Defendants' unique and special knowledge about the underlying loans and the underwriting standards of the mortgage originators, created a special relationship of trust, confidence, and dependence between Defendants and BayernLB.

112. Defendants were aware that BayernLB relied on their unique and special expertise and experience and depended upon them for accurate and truthful information. Defendants also knew that the facts regarding the originators' compliance with their underwriting standards were exclusively within Merrill Lynch's knowledge.

113. Based on their expertise, superior knowledge, and relationship with BayernLB, Defendants owed a duty to BayernLB to provide complete, accurate, and timely information regarding the mortgage loans and the RMBS. Defendants breached their duty to provide such information.

114. Defendants likewise made misrepresentations, which they were negligent in not knowing at the time to be false, in order to induce BayernLB's investment in the RMBS. Defendants provided the Offering Materials to BayernLB in connection with the RMBS for the purpose of informing BayernLB of material facts necessary to make an informed judgment about whether to purchase the RMBS. In providing these documents, Defendants knew that the information contained and incorporated therein would be used for a serious purpose, and that BayernLB, like other reasonably prudent investors, intended to rely on the information.



115. As alleged above, the Offering Materials contained materially false and misleading information.

116. Defendants should have known that the information in the Offering Materials was materially false and misleading.

117. Unaware that the Offering Materials contained materially false and misleading statements, BayernLB reasonably relied on those false and misleading statements when deciding to purchase the RMBS in the offerings.

118. BayernLB purchased RMBS from Defendants Merrill Lynch, Pierce, Fenner & Smith Inc. and Merrill Lynch Mortgage Investors, Inc. and is therefore in privity with those Defendants.

119. Based on Defendants' expertise and specialized knowledge, and in light of the false and misleading representations in the Offering Materials, Defendants owed to BayernLB a duty to provide it with complete, accurate, and timely information regarding the quality of the RMBS, and breached their duty to provide such information to BayernLB.

120. BayernLB reasonably relied on the information provided by Defendants and BayernLB purchased Certificates that were worth far less than what it paid for them at the time of purchase, and BayernLB has suffered substantial damages as a result of Defendants' misrepresentations.

### **PRAYER FOR RELIEF**

**WHEREFORE**, Plaintiff prays for relief and judgment, as follows:

(a) Awarding rescission and compensatory and/or rescissory damages in favor of Plaintiff against all Defendants, jointly and severally, for all damages sustained as a result of Defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

(b) Awarding punitive damages for Plaintiff's common-law fraud claims;

(c) Awarding Plaintiff its reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

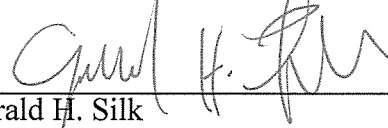
(d) Such other relief as the Court may deem just and proper.

**JURY DEMAND**

Plaintiff demands a trial by jury on all claims so triable.

Dated: May 2, 2012

**BERNSTEIN LITOWITZ BERGER  
& GROSSMANN LLP**



---

Gerald H. Silk

Avi Josefson

Ross Shikowitz

1285 Avenue of the Americas, 38th Floor

New York, NY 10019

Tel: (212) 554-1400

Fax: (212) 554-1444

[jerry@blbglaw.com](mailto:jerry@blbglaw.com)

[avi@blbglaw.com](mailto:avi@blbglaw.com)

[ross@blbglaw.com](mailto:ross@blbglaw.com)

*Counsel for Plaintiff*