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

CIFG ASSURANCE NORTH AMERICA, INC., Plaintiff, -against- J.P. MORGAN SECURITIES LLC, (f/k/a "Bear, Stearns & Co. Inc.") Defendant.	Index No.: **COMPLAINT**

Plaintiff CIFG Assurance North America, Inc. ("CIFG"), by and through its attorneys, Quinn Emanuel Urquhart & Sullivan, LLP, for its Complaint against Defendant J.P. Morgan Securities LLC ("JP Morgan"), formerly known as Bear, Stearns & Co. Inc. ("Bear Stearns"), alleges as follows:

PRELIMINARY STATEMENT

1. This action arises out of Bear Stearns' fraudulent scheme to induce CIFG to provide financial guaranty insurance on credit default swaps ("CDS") guaranteeing senior tranches of two collateralized debt obligations ("CDOs")—ACA ABS CDO 2006-2 Ltd. ("ACA 2006-2") and Libertas Preferred Funding II, Ltd. ("Libertas II"). ACA 2006-2 and Libertas II were created by Bear Stearns to transfer the risk on numerous toxic residential mortgage-backed securities ("RMBS") on its books to investors and insurers like CIFG. To persuade CIFG to provide insurance on these CDOs—without which the CDOs would not have closed, leaving Bear Stearns to bear the losses on the RMBS itself—Bear Stearns represented that the CDOs'

portfolios would be selected and managed by reputable collateral managers—namely, ACA Management, L.L.C. ("ACA") and Strategos Capital Management, LLC ("Strategos")—acting independently and in good faith in the interests of long investors. In fact, as Bear Stearns was well aware, but CIFG was not, the collateral for these CDOs was selected not by ACA and Strategos but by Bear Stearns itself, which not only stocked the CDOs with toxic RMBS but also profited from short positions it took against the CDOs' portfolios. Bear Stearns persuaded ACA and Strategos to allow it to select collateral for these CDOs by offering them large fees and the promise of further lucrative deal volume. As a result of its fraud, Bear Stearns was able to pass off huge losses onto CIFG, which had to pay over $100 million to discharge its liabilities under the Guaranties when ACA 2006-2 and Libertas II collapsed.

2. Bear Stearns was a leading participant in the RMBS market during the period 2000-2007, dramatically increasing its market share by purchasing and securitizing huge volumes of loans though various subsidiaries. In 2006—the year both ACA 2006-2 and Libertas II closed—Bear Stearns ranked as the number one underwriter of mortgage-backed securities. However, Bear Stearns did not achieve this growth honestly. As a suit recently filed by the New York Attorney General alleges, Bear Stearns committed multiple fraudulent and deceptive acts in promoting and selling its RMBS, representing to investors that it had carefully evaluated the collateral underlying these securities when in fact it had systematically failed to properly evaluate the loans and largely ignored the defects that its limited review did uncover. As a result, Bear Stearns not only caused huge losses to investors on securities that it packaged and sold, but also found itself with a large volume of toxic RMBS remaining on its own books which it was desperate to offload.

3. Bear Stearns also found itself with a large number of other toxic RMBS on its books, underwritten by other entities, through two of its funds, managed by Ralph Cioffi and Matthew Tannin (the "Cioffi Funds"). The Cioffi Funds had taken highly leveraged positions in CDOs backed by subprime RMBS, and were therefore exposed to massive losses when subprime mortgages began to default in large numbers. According to the SEC, in a recently settled complaint, Cioffi and Tannin attempted to stave off the collapse of the Cioffi Funds by misrepresenting to investors the levels of redemptions from the Cioffi Funds, the condition of the Cioffi Funds, and the composition of their portfolios. But the scale of the Cioffi Funds' losses was so large that this was not enough. Accordingly, in addition, Bear Stearns sought to reduce its exposure on the toxic RMBS in the Cioffi Funds, as well as on the toxic RMBS it had underwritten itself, by transferring some of the risk on both sets of loans to CDOs created specifically for the purpose and then offloading the CDOs to investors. This was the purpose for which ACA 2006-2 and Libertas II were secretly created.

4. In order to make these CDOs marketable, Bear Stearns had to find someone to insure the senior tranches of the CDOs, and it also had to find someone to act as collateral manager for the transactions, to reassure investors that this critical function would be performed by a reputable and experienced independent asset manager. Thus, Bear Stearns represented, both orally and in the offering materials relating to the transactions, that the collateral for ACA 2006-2 and Libertas II would be selected by ACA and Strategos respectively, acting independently and in good faith in the interests of long investors. With respect to ACA 2006-2, Bear Stearns expressly represented that Bear Stearns would *not* have any say in collateral selection—which was necessary because 35% of ACA was owned by Bear Stearns, creating an obvious risk of undue influence.

5. In reliance on these representations, and after performing extensive due diligence with respect to both the CDOs' portfolios and the collateral managers' qualifications, CIFG agreed to provide financial guaranty insurance on credit default swaps guaranteeing payment on \$400 million of Class A-1LA notes issued by ACA 2006-2 (the "ACA 2006-2 Guaranty"), and \$325 million of Class A-1 notes issued by Libertas II (the "Libertas II Guaranty") (together, the "Guaranties"). In fact, however, contrary to Bear Stearns' representations, ACA and Strategos did not independently select the collateral for ACA 2006-2 and Libertas II. Rather, they allowed Bear Stearns to direct the selection of the collateral, which enabled Bear Stearns to offload the risk on much of its own portfolio to both CDOs, directly contrary to the interests of long investors in the CDOs, and thus also directly contrary to the interests of CIFG.

6. At Bear Stearns' direction, ACA agreed to include at least \$206 million of RMBS from Bear Stearns' books in the portfolio of ACA 2006-2—*i.e.*, 27% of the total portfolio. These RMBS included a disproportionate share of the most toxic assets in the portfolio. For example, nine of the first eleven RMBS to default in the portfolio came from Bear Stearns' inventory. Moreover, the average life before default of the non-Bear Stearns collateral in the portfolio was 28% longer than that of the Bear Stearns collateral. Similarly, at Bear Stearns' behest, Strategos agreed to include at least \$80 million of toxic RMBS from Bear Stearns' inventory in the Libertas II portfolio, representing 16% of the total portfolio. Again, these RMBS turned out to be the most toxic assets in the portfolio: the average life before default of the non-Bear Stearns collateral was 33% longer than that of the Bear Stearns collateral.

7. Further confirming the toxic nature of the RMBS in ACA 2006-2 and Libertas II, both of these CDOs failed extraordinarily quickly. ACA 2006-2 suffered an Event of Default only 0.93 years after closing, and Libertas II defaulted only 1.25 years after closing. These

failures were much more rapid than those of comparable CDOs created during this period. Even the notorious ABACUS 2007 AC-1 CDO ("ABACUS"), which was also managed by ACA but for which the collateral was actually selected by Goldman, Sachs & Co. ("Goldman") and Paulson & Co ("Paulson"), to further Paulson's massive shorts against the ABACUS portfolio, lasted 1.25 years before defaulting. Goldman recently paid $550 million to settle claims brought by the SEC with respect to its conduct on ABACUS.

8. There was also a remarkably high overlap between the portfolios of ACA 2006-2 and the portfolios of other CDOs which were managed by ACA or Strategos, but which were stocked with toxic assets at the behest of net short investors who deliberately built these CDOs to fail. Thus, approximately 40% of the ACA 2006-2 portfolio—and approximately *half* of the subprime portion of the portfolio (the portion most likely to default)—was included in the portfolios of both ABACUS and ACA Aquarius ("Aquarius"), for which ACA also acted as collateral manager but which was actually controlled by net short investor Magnetar Capital LLC. Even more strikingly, almost *three-quarters* of the Libertas II portfolio was included in the portfolio of Scorpius CDO ("Scorpius"), a deal for which Strategos acted as collateral manager but which was in fact controlled by Magnetar. Further, approximately one-third of the Libertas II portfolio was also included in two other Magnetar deals which were also built to fail—Norma CDO ("Norma") and Auriga CDO ("Auriga"). Magnetar and its structurers and collateral managers have faced claims totaling billions of dollars for their misconduct on deals controlled by Magnetar, including Norma.

9. Moreover, Bear Stearns did not merely seek to reduce its RMBS exposure by dumping toxic assets into ACA 2006-2 and Libertas II. Like Magnetar and Paulson, it also shorted these assets in an attempt to hedge some of its remaining exposure on its RMBS

portfolio. This is confirmed not only by the fact that the portfolios were built to fail—and were thus perfect targets for a short investor—but also by the fact that $150 million (20%) of the ACA 2006-2 portfolio consisted of a disguised synthetic investment (*i.e.*, a credit default swap referencing an asset, rather than a direct acquisition of the asset) in the ABX 6-1 BBB- Index of low-rated RMBS. This investment had to be disguised because the ACA 2006-2 portfolio concentration limit on investments in the ABX 6-1 BBB- Index was only 1.5%; it was set at this low level to prevent the CDO from being exposed to excessive risk. Given that Bear Stearns had begun taking large short positions against the ABX 6-1 Index as early as February 2006, the most plausible explanation for this disguised investment is that it was designed to provide Bear Stearns with the opportunity to take the short side of the CDS, and thus to make a $150 million bet against the ABX 6-1 BBB- Index at ACA 2006-2's expense. Even if, implausibly, the short counterparty were not Bear Stearns, this disguised investment was clearly made at the behest of an entity other than ACA, contrary to Bear Stearns' representations that ACA would independently select the collateral for ACA 2006-2.

10. Thus, by controlling collateral selection for ACA 2006-2 and Libertas II, Bear Stearns was not only able to offload the risk on large numbers of toxic assets it had on its books, but it also likely profited from short positions it took against these CDOs.

11. Had CIFG been aware that ACA and Strategos were not selecting the collateral for ACA 2006-2 and Libertas II, as Bear Stearns had represented, but were in fact taking direction from Bear Stearns with respect to collateral selection, and that Bear Stearns' interests in the CDOs were adverse to the interests of long investors, CIFG would never have entered into the Guaranties. But CIFG was not aware and could not have learned of these facts through the

exercise of reasonable diligence. As a result, CIFG was obliged to pay over $100 million to discharge its liabilities under the Guaranties when ACA 2006-2 and Libertas II failed.

12. CIFG therefore brings claims of material misrepresentation in the inducement of an insurance contract and fraud against Bear Stearns, and seeks rescissory, compensatory, and punitive damages to redress its losses.

THE PARTIES

Plaintiff

13. CIFG is a New York stock insurance company with its corporate headquarters and principal place of business at 850 Third Avenue, New York, New York 10022. CIFG is licensed by the New York State Insurance Department to conduct surety, credit, residual value, and financial guaranty insurance.

Defendant

14. J.P. Morgan Securities LLC, formerly known as J.P. Morgan Securities Inc. ("J.P. Morgan"), is a subsidiary of JPMorgan Chase & Co., which is a financial holding company incorporated in Delaware and principally located at 270 Park Avenue, New York, New York 10017.

15. At all relevant times, Bear, Stearns & Co. Inc. ("Bear Stearns") was an SEC-registered broker-dealer and a subsidiary of The Bear Stearns Companies Inc. ("The Bear Stearns Companies"), principally located at 383 Madison Avenue, New York, New York 10179. Bear Stearns served as an underwriter for all of the securitizations at issue in this case.

16. On May 30, 2008, a wholly owned subsidiary of JPMorgan Chase & Co. merged with and into The Bear Stearns Companies, including Bear Stearns, becoming a wholly owned subsidiary of JPMorgan Chase & Co.

17. On or about October 1, 2008, Bear Stearns merged with an existing subsidiary of JPMorgan Chase & Co. known as J.P. Morgan Securities Inc. The resulting entity did business as J.P. Morgan Securities Inc. Effective September 1, 2010, J.P. Morgan Securities Inc. converted from a corporation to a limited liability company, and changed its name to J.P. Morgan Securities LLC (defined above as "J.P. Morgan"). Accordingly, all allegations against Bear Stearns are made against its legal successor, J.P. Morgan.

JURISDICTION AND VENUE

18. This Court has jurisdiction over this proceeding pursuant to CPLR §§ 301 and 302. J.P. Morgan is a New York Corporation and has its principal place of business in New York.

19. Venue is proper in the Supreme Court of the State of New York, New York County because Bear Stearns' actions took place in New York, New York, where Bear Stearns conducted business.

FACTUAL BACKGROUND

I. Collateralized Debt Obligations

20. A CDO is a special purpose financial vehicle that purchases, or assumes the risk of, a portfolio of assets (the "portfolio")—such as bonds or loans—and issues securities which then make payments to investors from the income generated by the assets in the portfolio. A CDO's portfolio can include a variety of assets, like commercial or residential mortgage-backed securities ("CMBS" and "RMBS," respectively), securities issued by other CDOs, or credit default swaps ("CDS") referencing those types of obligations. When a CDO performs as designed, the assets that form the CDO portfolio generate a stream of cash flows (*e.g.*, from mortgage payments) that the CDO uses to pay its expenses and make interest and principal payments to the CDO's note holders. Any remaining cash flows go to the CDO's equity

investors. Whether a CDO's issued securities will be repaid in full depends primarily on the CDO's structure and the credit quality (and subsequent performance) of the portfolio of assets in the CDO. Thus, for a CDO comprised primarily of RMBS, CDO noteholders will be more likely to receive promised payments of interest and principal if the rate of collection on the underlying individual mortgages is high. Obviously, the higher the credit quality of the mortgages in the portfolio, the more likely that payments to the CDO noteholders will be made. Just as obviously, the converse is also true. So, from the investor's perspective nothing is more important than the skill and judgment of the entity selecting which assets to put into the CDO's portfolio.

21. To buy their portfolio of assets, CDOs raise money from investors by issuing multiple classes of notes and equity interests. A CDO's notes are not all subject to the same level of risk. Rather, CDOs issue notes in "tranches" representing different levels of risk (and therefore potential reward). This is achieved by creating a hierarchical structure of note holders in the CDO. The senior tranche of a CDO typically receives the highest "AAA" rating. "Super senior" CDO tranches, which are intended to be even more remote from loss, are senior to another tranche that is also rated AAA. Because the most senior tranches receive proceeds from the CDO portfolio first, they bear the lowest risk of sustaining losses in the CDO structure.

22. Correspondingly, CDO notes do not all offer the same level of anticipated return to their purchasers. The interest on CDO notes is set according to their expected level of risk. More junior tranches generally offer higher interest, but are exposed to a higher risk of shortfalls, because their position in the CDO structure exposes them to losses in the portfolio before the more senior notes. The more senior tranches, on the other hand, receive lower investment returns because they benefit from greater subordination and thus carry lower risk.

23. Rating agencies typically assign ratings to the tranches of a CDO—except for the equity or income tranche (if any). The rating agencies also assign ratings to the underlying assets that are either held or referenced by the CDO. The risk of default on AAA tranches issued by a CDO should be remote if: (a) the portfolio includes only securities of credit quality commensurate with expected loss rates; and (b) the amount of subordination is set properly, according to the quality of the portfolio, to absorb potential losses so that the risk of default affecting the senior tranches is extremely remote. Therefore, one of the most critical determinants of a CDO's performance is the selection and management of its portfolio.

II. The Role Of The Collateral Manager.

24. The assets that are included in a CDO are typically selected by a collateral manager. The collateral manager is expected to use its best efforts in managing the CDO portfolio. Managing a CDO portfolio typically involves, among other things, selecting the assets for inclusion in the initial portfolio, monitoring the credit status of the individual underlying assets, reinvesting payment proceeds from maturing underlying assets, and making substitutions in the portfolio of assets to the extent consistent with the CDO's operative agreements. A collateral manager, therefore, can greatly impact a CDO's performance and either lower—or raise—its risk profile. It almost goes without saying that the expertise of the collateral manager is critical.

25. As explained by Ian Giddy, Professor of Finance at the Stern School of Business at New York University:

> [T]the manager's expertise with the assets and ability to manage within established constraints is ***paramount*** to the success of the CDOs. ***Market consensus is that the manager is the most important factor in the performance of a CDO.***

"The CDO Product," by Ian Giddy, Professor of Finance at the Stern School of Business at New York University (emphasis added). Indeed, as Bear Stearns itself stated in the Offering Circular for ACA 2006-2 (and, in materially identical language, in the Offering Circular for Libertas II): "The performance of the Collateral Debt Securities *depends on the skills of the Collateral Manager* and its Affiliates *in analyzing, selecting and managing the Collateral Debt Securities*. As a result, the success of the Issuer will be *highly dependent on the financial and managerial experience of the Collateral Manager* and the individuals to whom the task of managing the Collateral has been assigned." (p. 49) (Emphasis added.)

26. Fundamental to the collateral manager's role is that it will act independently and will serve, first and foremost, the interests of the CDO's investors. As explained by the former Co-Head of Global CDOs at Citigroup in testimony to the U.S. Financial Crisis Inquiry Commission ("FCIC") in April 2010: "The collateral manager's role was to . . . manage and trade the collateral pool for the benefit of the debt and equity issued by the CDO."

27. Investors rely heavily on the collateral manager's professed sophistication in analyzing and selecting assets for the CDO's portfolio. Collateral managers are paid a fee for their services, typically a percentage of the notional value of the transaction (*i.e.,* the total face amount of all securities issued by the CDO), the cost of which is ultimately paid by the CDO investors.

28. Most of a CDO's initial portfolio of assets are selected by the collateral manager in the months before the CDO's closing. Because the CDO has not yet raised any capital during that period (which, along with any post-closing period in which the CDO continues to acquire its portfolio, is known as the "ramp up period"), the pre-closing acquisition of assets is funded pursuant to a CDO "warehousing facility" between the collateral manager and the warehousing

facility provider, which is usually the bank structuring the transaction (here, Bear Stearns). If the CDO fails to close, the warehousing facility provider is usually at risk for assets that had already been acquired for the CDO's portfolio. Upon the CDO's closing, however, all of the assets that were acquired pursuant to the warehousing facility are transferred to the CDO (so long as they still qualify under the eligibility criteria that are established for the CDO), with the warehousing facility provider receiving reimbursement via the funds raised by the CDO through its issuance of notes and equity. After the CDO closes, the collateral manager typically continues to acquire assets for the CDO portfolio until it is fully "ramped up" (*i.e.,* complete). The collateral manager also manages the acquired underlying assets pursuant to the terms of the CDO's indenture and a collateral management agreement between the CDO and the collateral manager setting forth the collateral manager's responsibilities.

III. Credit Default Swaps: A Form of Credit Protection (Like Insurance).

29. Credit default swaps are commonly used forms of credit protection (similar to credit insurance) in which, in return for the payment of premiums by one party (the "buyer" of credit protection), the counterparty (the "seller" of credit protection) agrees to make payments upon the occurrence of one or more agreed-upon "Credit Events" (as defined in the CDS transaction documents). These Credit Events generally include a default by the issuer of a specified security to pay when due the principal of or interest on that security. In general, the buyer of credit protection has a "short" position with respect to the specified security, since it will be entitled to a payment if the specified security defaults. Conversely, the seller—and through the seller, the guarantor—of credit protection has a "long" position with respect to the specified security, since it bears the risk of default by the issuer on that security.

IV. Bear Stearns' Fraudulent RMBS Program

30. Between 2000 and 2007, Bear Stearns actively sought to play an ever larger role in the RMBS market by dramatically increasing the volume of loans it purchased and securitized and by touting its industry-leading position as an underwriter and market-maker in residential mortgages.

31. Bear Stearns generated loans for securitization through its own mortgage origination platform, Bear Stearns Residential Mortgage Corporation ("BSRMC"), and through a subprime mortgage originator, Encore Credit Corporation, which it acquired in or about early 2007. In addition, another Bear Stearns subsidiary, EMC Mortgage Corp. ("EMC"), purchased loans for securitization from financial institutions and other secondary mortgage-market sellers. EMC's affiliate, EMC Residential Mortgage Corporation ("EMCRMC"), provided credit to mortgage lenders through its warehouse lines of credit, as did BSRMC.

32. Bear Stearns' RMBS business was enormously profitable. In its public filings, Bear Stearns boasted throughout 2005, 2006, and 2007 of being a market leader in mortgage-backed securitizations. In 2006, Bear Stearns ranked as the number one underwriter of mortgage-backed securities, capturing 11% of the overall U.S. mortgage securities market. Moreover, as a result of its "vertically integrated model" that generated revenue, as the FCIC noted, "at every step, from loan origination through securitization and sale." Bear Stearns took in money from a variety of sources, including: (i) loan fees on loans originated by Bear Stearns affiliates, including EMC and BSRMC; (ii) proceeds from the sale of RMBS to investors; (iii) fees from underwriting mortgage-backed securities; (iv) fees from servicing of the securitized loans; (v) fees from CDOs into which these securities were repackaged; (vi) gains and fees from trading in these securities and interest in the CDOs into which they were placed; and (vii)

management fees and carried interest from hedge funds and other investment vehicles that invested in the vast array of securities and financial products structured by Bear Stearns.

33. Bear Stearns did not achieve these gains, however, without sacrificing quality to quantity and integrity to profit. In fact, as the New York Attorney General alleges in its lawsuit against Bear Stearns, Bear Stearns committed multiple fraudulent and deceptive acts in promoting and selling its RMBS. For example, in publicly filed documents and marketing materials, Bear Stearns represented to investors that it had taken a variety of steps to ensure the quality of the loans underlying its RMBS, including confirming that these loans were originated in accordance with the applicable underwriting guidelines, *i.e.*, the standards in place to ensure, among other things, that loans were extended to borrowers who demonstrated the willingness and ability to repay.

34. While the "due diligence" review that Bear Stearns represented it undertook should have assessed the quality of the loans deposited into its RMBS, Bear Stearns' actual due diligence process was very different from its public representations. Bear Stearns failed to use due diligence as a tool to identify and eliminate the many defective loans that it purchased from originators. Rather, in order to preserve its relationships with loan originators and to ensure its ability to secure the massive quantity of loans it sought for its securitization machine, Bear Stearns routinely overlooked defective loans that were identified through the due diligence review and ignored deficiencies that it knew existed in the due diligence review process itself. As an internal Bear Stearns document dated July 2007 acknowledged, in addition to having "wide guidelines," Bear Stearns "abused the controls of them," creating a "perfect storm."

35. Bears Stearns was aware that many of its loan originators were selling defective loans, but in its search for ever greater profits continued to buy and securitize these loans

nonetheless. Numerous originators who were top contributors to Bear Stearns' RMBS ended up on the Comptroller of the Currency's "Worst Ten" mortgage originators in the "Worst Ten" metropolitan areas due to their loans' high rate of foreclosures during the period 2005 to 2007. Many have been the subject of private and government lawsuits and investigations based on allegations of, among other things, their systemic abandonment of underwriting standards. Multiple witnesses—former employees of these originators—have confirmed these allegations and painted a clear picture of the pressure during these years to approve as many loans as possible.

36. At least one of those originators—American Home Mortgage ("AHM")—has also been implicated in a criminal matter. In March 2008, an AHM sales executive pleaded guilty to federal criminal charges of mortgage fraud, for intentionally inflating a borrower's income in order to get a loan approved, and further informed the court at sentencing that he had been encouraged by AHM management to manipulate the loans in order to increase sales. Indeed, according to a June 2006 internal Bear Stearns email, almost 60% of loans originated by AHM that were purchased by EMC were 30 or more days delinquent. Nevertheless, after learning this, Bear Stearns went on to issue over 30 subprime and Alt-A securitizations that included AHM loans.

37. Other internal communications reflect Bear Stearns' awareness of the poor quality of loans that it was including in other securitizations. In connection with the Bear Stearns Second Lien Trust 2007-1 ("BSSLT 2007-1"), for example, one Bear Stearns executive asked whether the securitization was a "going out of business sale" and expressed a desire to "close this dog." In another internal email, the SACO 2006-8 securitization was referred to as a "SACK OF SHIT" and a "shit breather." Not surprisingly, the cumulative losses for these securitizations

have been profound, amounting to over 75% of the original balance of BSSLT 2007-1 and over 43% of the original balance of SACO 2006-8.

38. Analysis of loan pools underlying Bear Stearns' RMBS has confirmed pervasive non-compliance with underwriting guidelines. In its amended complaint against Bear Stearns, for example, the Federal Housing Finance Agency ("FHFA") analyzed mortgage loans underlying the BSMF 2007-AR3 securitization (comprised of Alt-A collateral) and the BSABS 2006-AQ1 securitization (comprised of subprime collateral), among others. As FHFA's amended complaint alleges, the vast majority of loans in the samples reviewed—523 of 535 loans from BSMF 2007-AR3 and 387 of 426 loans from BSABS 2006-AQ1—did not meet the applicable guidelines.

39. The systemic abandonment of underwriting guidelines by Bear Stearns' originators had a grave impact on the quality of loans that made their way into Bear Stearns' RMBS, as evidenced by the dramatic rise in default rates on the loans underlying the RMBS. Largely as a result of these delinquencies and defaults, Bear Stearns' RMBS have suffered tremendous losses. The current cumulative realized losses on over 100 subprime and Alt-A securitizations for which Bear Stearns or one of its affiliates was the sponsor and underwriter in the years 2006 and 2007 alone total approximately $22.5 billion, or approximately 26% of the original principal balance of approximately $87 billion.

40. In addition to experiencing extraordinary rates of delinquency, the credit ratings of these securities have been drastically downgraded. Today, many of the tranches in Bear Stearns' RMBS have been downgraded from investment grade to "junk-bond" status.

41. In order to promote its RMBS, Bear Stearns had purchased substantial tranches of the equity in these deals. Thus, as a result of its extensive fraud, Bear Stearns not only caused

investors in its RMBS to suffer huge losses, but also found itself with a large volume of toxic RMBS on its own books which it was desperate to offload.

V. The Cioffi Funds

42. Bear Stearns also had massive exposure to toxic RMBS which it had not underwritten itself, through the Cioffi Funds, managed by Ralph Cioffi and Matthew Tannin. The Cioffi Funds—the Bear Stearns High-Grade Structured Credit Strategies Fund and the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund—had taken highly leveraged positions in CDOs backed by subprime RMBS, and ultimately collapsed in June 2007, causing investor losses of approximately $1.8 billion. Cioffi's and Tannin's efforts to stave off collapse as their Funds suffered increasingly large losses resulted in securities fraud claims being brought against them by the SEC in 2008, which were settled earlier this year. Among other things, the SEC alleged that Cioffi and Tannin brought in new money and persuaded existing investors and counterparties not to withdraw their money by defrauding investors as to the level of redemptions from the Cioffi Funds—including lying about Cioffi's own personal redemption from one of the Cioffi Funds; by misrepresenting the current state of the Cioffi Funds; and by misrepresenting the composition of the Cioffi Funds' portfolios. Bear Stearns, Cioffi and Tannin have also been sued by private investors in at least three private actions relating to their misconduct with respect to the Cioffi Funds.

43. Cioffi's and Tannin's efforts to stem the flow of redemptions from the Cioffi Funds were not sufficient to stave off the threat of collapse. Thus, Bear Stearns was desperate to offload its exposure on as many of these RMBS as possible. Bear Stearns was also desperate for opportunities to further hedge its losses on both the RMBS it had underwritten itself and the RMBS held by the Cioffi Funds by shorting these RMBS.

VI. Bear Stearns' Representations as to ACA 2006-2 and Libertas II

44. Bear Stearns sought to reduce its exposure on its toxic RMBS by offloading them to CDOs and marketing the CDOs to investors. However, in order to make the CDOs marketable, Bear Stearns had to find insurers, like CIFG, who would guarantee payment on the senior tranches of the CDOs. Bear Stearns also had to reassure investors and insurers that the CDOs' portfolios would be selected and managed by reputable collateral managers acting independently and in good faith in the interests of long investors.

45. Because the portfolios of both ACA 2006-2 and Libertas II included more than 100 RMBS, each of which in turn referenced thousands of mortgage loans, and because many of the RMBS in each CDO were originally underwritten or owned by Bear Stearns, Bear Stearns had far more knowledge about the quality of the assets included in these CDOs than CIFG. Thus, as Bear Stearns knew, CIFG depended heavily on Bear Stearns' representations concerning ACA's and Strategos' independence in the collateral selection process to ensure that the highest quality RMBS within the eligibility criteria for each CDO were selected for the CDOs' portfolios.

46. ACA and Strategos were both highly reputable collateral managers at the time ACA 2006-2 and Libertas II were created. For example, the Financial Times has stated: "In early 2007 … ACA was still very much regarded as a CDO manager *par excellence.*"

47. CIFG's dependence on ACA's expertise and independence was reflected, among other things, in its Underwriting Guidelines, which were designed to ensure that CIFG adhered to "conservative credit guidelines" and that CIFG underwrote transactions to a "zero loss standard" (meaning that "an insured transaction is not expected to result in a claim through its term despite significant worsening of those conditions, general economic or specific to the transaction, that support its creditworthiness at the outset"). CIFG's Underwriting Guidelines stipulated that the

number one priority for cash flow CDOs CIFG was considering insuring (like ACA 2006-2 and Libertas II) was a thorough review of the asset manager, and that this must include: (1) background checks on all key personnel; (2) review of the depth of key personnel; (3) interviews with senior management responsible for portfolio management and credit analysis; (4) review of the manager's credit scoring system (including length of time the system had been in use, how it correlated to the rating agencies, consistency between its charge-off experience and credit scores, and random review of individual files and credit scores; and (5) review of the manager's historical portfolio performance (including its performance compared to an appropriate index, the volatility of its performance to that index, its performance adjusted by excluding its several largest gains, and its performance during the 1990-91 recession).

48. Had Bear Stearns disclosed that collateral selection for ACA 2006-2 and Libertas II was actually being directed by Bear Stearns, much less that it was shifting its own toxic assets into the CDOs and taking short positions against them, contrary to the interests of long investors, CIFG would never have agreed to provide insurance on the CDOs, and the CDOs would never have closed.

A. Representations as to ACA 2006-2

49. In early August 2006, Bear Stearns approached CIFG to solicit financial guaranty insurance on the ACA 2006-2 Swap, a CDS which would guarantee $400 million of Class A-1LA Senior Secured Floating Rate Notes issued by ACA 2006-2.

50. To induce CIFG to enter into the ACA 2006-2 Guaranty, Bear Stearns made numerous representations to the effect that the collateral for ACA 2006-2 would be selected by ACA acting independently and in good faith in the interests of long investors. Thus, for example, the Pitchbook for ACA 2006-2, dated September 21, 2006, which was prepared by both Bear Stearns and ACA and was provided to CIFG by Bear Stearns, stated prominently that the

CDO would be "[m]anaged by ACA Management, L.L.C." (front page) and that "ACA will serve as the CDO Collateral Manager". The Pitchbook further touted ACA's expertise in the prudent selection and management of asset-backed securities ("ABS"), including RMBS—which was only material if ACA was selecting the collateral for ACA 2006-2. Thus, among other things, the Pitchbook represented that:

- "As of June 2006, ACA managed 17 CDOs with approximately $12.2 billion assets under management, 11 of which are ABS CDOs, aggregating to approximately $8.7 billion in assets."
- "ACA has more than 28 professionals fully dedicated to the CDO asset management business representing a combination of skills and experience relating to credit underwriting."
- "No Class of Notes of a CDO managed by ACA has been downgraded or put on credit watch negative."
- ACA's "Investment Philosophy" is that "Asset selection and asset management [are] premised on credit fundamentals and then optimized for relative value."
- "ACA Management will utilize proprietary models to stress and confirm the adequacy of cash flows."
- ACA's investment goals include to "[p]reserve capital," to engage in "[d]efensive trading," and to "[m]inimize real market exposure."

51. The Pitchbook described in detail ACA's method of ranking sellers and servicers of prospective collateral; the additional, intensive analysis it performed on below investment grade companies; and the numerous other elements it took into account in determining whether to purchase collateral for a portfolio, including: "Asset Level Analysis;" "Historic Static Pool Data: delinquencies, loss, recoveries, prepayments;" "Collateral origination channel: wholesale/retail;" "Portfolio growth rate, expectation of and timing of excess spread generated by the loan pool;" and "Set expected net losses and loss curve."

52. Between early August 2006 and October 2006, CIFG performed extensive due diligence relating to ACA 2006-2. During this period, CIFG had numerous communications,

both written and oral, with Bear Stearns and ACA (through Bear Stearns) concerning ACA's expertise and approach to portfolio selection generally and specifically with respect to ACA 2006-2. Most significantly, on September 22, 2006, CIFG representatives met with representatives of Bear Stearns and ACA at ACA's offices in New York City to assess ACA's strategy for selecting and managing the collateral for ACA 2006-2. During this meeting, Bear Stearns and ACA representatives made numerous oral representations as to ACA's expertise in ABS asset management and confirmed that ACA would independently select and manage the collateral for ACA 2006-2. Among other things, as reflected in the CIFG team's notes of the meeting, Bear Stearns and ACA represented that:

- ACA's "[c]redit culture is very strong and capital preservation is one of the pillars of ACA's credit process."
- The "[p]erformance of [ACA's] previous transactions remains very strong."
- ACA's "[p]ortfolio managers, senior executive staff and the structured finance team demonstrate[] sound experience in asset classes."
- "*[ACA's] ABS Credit team works together with the portfolio managers in analyzing and selecting all the securities that will go in the portfolios*. In addition, the ABS Credit team conducts quantitative research on credits, portfolio optimization and correlation." (Emphasis added.)
- ACA has "robust surveillance and monitoring systems and the[] ability to track all credits as well as triggers in their deals so as to minimize negative developments and optimize remediation."
- "ACA has been involved in the ABS CDS market since its inception," and "ACA usually gets bids from eight to twelve dealers" for prospective CDS investments.

53. At the September 22, 2006 meeting, Bear Stearns and ACA further represented to CIFG that, although Bear Stearns owned a 35% stake in ACA, "*all current business with Bear Stearns is conducted at arm's length*." (Emphasis added.)

54. In early October 2006, Bear Stearns provided CIFG with the portfolio for ACA 2006-2, which was 95% ramped at that stage. CIFG performed extensive due diligence on this

portfolio to determine its credit characteristics and how much loss the portfolio could bear before the A-1LA notes referenced by the ACA 2006-2 Swap would suffer losses, assuming the credit characteristics of the collateral yet to be added to the portfolio would comply with Bear Stearns' representations and be at least as strong as the collateral already selected for the portfolio.

55. Bear Stearns' and ACA's representations as to ACA's collateral management role were further confirmed by the Offering Circular for ACA 2006-2, dated November 27, 2006, which again was prepared by both Bear Stearns and ACA and was provided to CIFG by Bear Stearns. The Offering Circular stated that ACA would "perform certain administrative and management services for [ACA 2006-2], *including the selection of the Collateral Debt Securities*." (Emphasis added.) The Offering Circular further stated that ACA would "manage the *selection*, Acquisition and Disposition of, and the investment in, the Collateral Debt Securities ... in accordance with the terms of the Indenture and the Collateral Management Agreement and *based on the Collateral Manager's research, credit analysis and judgment*." (Emphasis added.)

56. The Offering Circular also stated that: "The performance of the Collateral Debt Securities *depends on the skills of the Collateral Manager* and its Affiliates *in analyzing, selecting and managing the Collateral Debt Securities*. As a result, the success of the Issuer will be *highly dependent on the financial and managerial experience of the Collateral Manager* and the individuals to whom the task of managing the Collateral has been assigned." (Emphasis added.)

57. In addition, the Offering Circular stated that: "In accordance with the Collateral Quality Tests and the Coverage Tests and other requirements set forth in the Indenture, and in accordance with restrictions and guidelines in the Collateral Management Agreement, the

Collateral Manager *will select the portfolio of Collateral Debt Securities and Eligible Investments ....*" (Emphasis added.)

58. The Offering Circular further expressly stated that Bear Stearns would have no say in the selection of the collateral for ACA 2006-2: "*Neither the Initial Purchaser [Bear Stearns] nor any of its Affiliates will select any of the Collateral Debt Securities or Eligible Investments to be acquired by the Purchaser.*" (Emphasis added.)

59. Finally, the Offering Circular stated that: "The Collateral Manager *will exercise the degree of skill and care consistent with industry standards for the management of a portfolio of investments similar to the investments described in this Offering Circular*, and no less than that which the Collateral Manager customarily exercises with respect to assets similar in nature and character to assets that it manages for itself and others in accordance with its existing practices and procedures relating to assets of the nature and character of such assets, *and will agree, in any event, to act in a prudent and commercially reasonable manner and in good faith in discharging its duties under the Collateral Management Agreement.*" (Emphasis added.)

60. In reliance on Bear Stearns' representations, CIFG agreed to enter into the ACA 2006-2 Guaranty. CIFG's reliance on Bear Stearns' representations is demonstrated, among other things, by the credit memorandum seeking approval for the deal, which stated: "*CIFG will be relying on the expertise of the collateral manager in the selection, monitoring and if necessary, the workout of the portfolio as well as complying with the parameters of the CDO.*" (Emphasis added.)

B. Representations as to Libertas II

61. In late November 2006, Bear Stearns approached CIFG to solicit financial guaranty insurance on the Libertas II Swap, a credit default swap which would guarantee payment on $325 million of Class A-1 Senior Secured Floating Rate Notes of Libertas II.

62. To induce CIFG to enter into the ACA 2006-2 Guaranty, Bear Stearns made numerous representations to the effect that the collateral for ACA 2006-2 would be selected by ACA acting independently and in good faith in the interests of long investors. Thus, for example, the Pitchbook for Libertas II, which was prepared by both Bear Stearns and Strategos and was provided to CIFG by Bear Stearns on November 30, 2006, stated prominently that the CDO would be "[m]anaged by Strategos Capital Management, LLC." The Pitchbook touted the expertise of both Strategos and its parent Cohen & Company ("Cohen") in selecting and managing collateral, and represented that Strategos would be responsible for selecting and managing the collateral for ACA 2006-2. Among other things, the Pitchbook represented that:

- "Strategos was established as the cornerstone of Cohen & Company's ABS and MBS business."
- "Cohen & Company was ranked the #1 CDO asset manager from 2004-2005 with over $9.9 billion in securities originated."
- "Strategos currently has $8.1 billion in ABS CDOs under management."
- "Cohen & Company is a focused and disciplined manager."

63. The Pitchbook described in detail Strategos' approach to determining whether to invest in RMBS, including its analysis of servicers and originators, its extensive analysis of the characteristics of the collateral itself, and its robust surveillance and risk management systems.

64. During December 2006 and January 2007, CIFG conducted extensive due diligence on Libertas II. During this period, CIFG had numerous communications, both written and oral, with Bear Stearns and Strategos (through Bear Stearns) concerning Strategos' expertise and approach to portfolio selection generally and specifically with respect to Libertas II. CIFG had five separate due diligence meetings with representatives of Bear Stearns, Strategos and Cohen to better evaluate Strategos' and Cohen's expertise and investment strategies. In the course of these meetings, Bear Stearns and Strategos made numerous oral representations as to

Strategos' ABS asset management expertise and discussed its approach to selecting and managing collateral generally. One of these meetings, on January 12, 2007, which included Alex Cigolle, the portfolio manager for Libertas II, related specifically to the collateral being selected for Libertas II and to Strategos' views on the subprime market. According to CIFG's notes of these meetings, Bear Stearns and Strategos represented, among other things, that:

- Strategos had a "[s]ound fundamental credit culture," "[c]ore expertise in structured products," and "good knowledge of credits."
- "If [the core Strategos team] have a disagreement on credit, *they take the conservative approach and avoid the credit. They don't buy bonds because they are cheap, they buy them because they are good with respect to credit.* They are also very concerned about franchise risk." (Emphasis added.)
- Strategos "believes[s] that there is a lot more tiering in the market now and they have to be careful in picking names."
- "On overall CDO purchase, [Strategos] carefully consider[s] the collateral, structure and the manager before investing."
- Specifically with respect to Libertas II, "*Strategos does a 'bottoms up' review of each RMBS collateral*, focusing on layered risk through cross stratification analysis. They look to see where performances will be in a few years as a big risk element is performance after the 'step down date.'" (Emphasis added.)

65. In early January 2007, Bear Stearns provided CIFG with the portfolio for Libertas II, which was 85%-ramped at that stage. CIFG performed due diligence on this portfolio to determine its credit characteristics and how much loss the portfolio could bear before the A-1LA notes referenced by the Libertas II Swap would suffer losses, assuming the credit characteristics of the collateral still to be added to the portfolio would comply with Bear Stearns' representations and be at least as strong as the collateral already selected for the portfolio.

66. Bear Stearns' representations were further confirmed by the Offering Circular for Libertas II, dated February 13, 2007, which again was prepared by both Bear Stearns and Strategos and was provided to CIFG by Bear Stearns. The Offering Circular stated that Strategos

would "perform certain investment management functions, *including directing and supervising the investment by the Issuer in Collateral Debt Securities*, during the period from the Closing Date to (and including) the last day of the Reinvestment Period, in Eligible Investments and in Synthetic Security Collateral.... The Collateral Manager will be authorized *to supervise and direct the investment and disposition of the Collateral Debt Securities and Eligible Investments,* with full authority and at its discretion (without specific authorization from the Issuer), on the Issuer's behalf and at the Issuer's risk." (Emphasis added.)

67. The Offering Circular also stated that: "The performance of the Collateral Debt Securities *depends heavily on the skills of the Collateral Manager in analyzing and selecting the Collateral Debt Securities*. As a result, the Issuer will be *highly dependent on the financial and managerial experience of the Collateral Manager and certain of the officers and employees of the Collateral Manager to whom the task of selecting and managing the Collateral has been assigned*." (Emphasis added.)

68. Finally, the Offering Circular stated that: "The Collateral Manager in performing its obligations under the Collateral Management Agreement *will act in good faith and exercise reasonable care* (i) using a degree of skill and attention no less than that which the Collateral Manager exercises with respect to comparable assets that it manages for itself and others and (ii) without limiting the foregoing, in a commercially reasonable manner consistent with customary standards, policies and procedures followed by institutional managers of national standing in connection with the management of assets of the nature and character of the Collateral Debt Securities (including Synthetic Securities) and Eligible Investments." (Emphasis added.)

69. In reliance on Bear Stearns' representations, CIFG agreed to enter into the Libertas II Guaranty. CIFG's reliance on Bear Stearns' representations is demonstrated, among

other things, by the credit memorandum seeking approval for the deal, which stated: "*CIFG will be relying on the expertise of the collateral manager in the selection, monitoring and if necessary, the workout of the portfolio as well as complying with the parameters of the CDO.*" (Emphasis added.)

VII. Bear Stearns' Misrepresentations and Omissions

70. Bear Stearns' representations were egregiously false. In fact, neither ACA nor Strategos independently selected the collateral for their respective CDO's portfolios. Rather, both ACA and Strategos allowed Bear Stearns to direct the selection of this collateral, which enabled Bear Stearns to offload toxic assets from its own books into the CDOs' portfolios, and to profit from short positions it took on those portfolios.

71. Indeed, ACA and Strategos were selected to manage these deals precisely because Bear Stearns knew they would allow Bear Stearns to influence collateral selection. Bear Stearns was the largest shareholder in ACA, and owned 35% of the company. Moreover, as discussed in detail below (*see* ¶¶ 83-91, *infra*), both ACA and Strategos had already demonstrated their willingness to cede influence over collateral selection on CDOs they were managing to investors, who turned out to have substantial short positions on the CDOs and whose interests were therefore directly opposed to those of long investors and insurers like CIFG.

72. Bear Stearns further ensured the cooperation of ACA and Strategos by rewarding them with large fees (which, in the case of ACA, also enured to Bear Stearns' benefit, since it owned 35% of ACA), and by ensuring that ACA and Strategos received both these fees and proportionally higher cash distributions from the CDOs (by way of returns on equity positions) than senior noteholders, even after the CDOs began to fail. Thus, not only were ACA 2006-2 and Libertas II designed to enable Bear Stearns to offload toxic assets from its books, but they were also structured to pay out as much as possible to Bear Stearns, ACA and Strategos before—

and even after—they failed (when Bear Stearns actually made a profit from its short positions), while leaving long investors and CIFG to deal with massive losses.

73. ACA's senior collateral management fee on ACA 2006-2 was 20 basis points ("bps") or 0.2% of the portfolio balance, and its subordinate fee was 15bps. In addition, ACA was entitled to receive a Collateral Manager Incentive Allocation of 20% of net profits after an internal rate of return of 14% was paid to Preference Shares. This total fee was extremely high for a collateral manager, especially considering that the deal was static (*i.e.*, it required little management after the deal closed). Thus, ACA was paid $5,516,106 in senior and subordinated fees alone for its putative management of ACA 2006-2, even though it was the collateral manager for fewer than sixteen months before it was replaced by Solidus in April 2008. Moreover, these fees continued to be paid long after ACA 2006-2 failed. ACA received $3,184,503 (58% of its total fees) during the nine months after ACA 2006-2 began failing collateral quality tests in July 2007; and it received $1,439,306 (26% of its total fees) after ACA 2006-2 suffered an Event of Default in early November 2007. Further confirming how well ACA was rewarded for its role on ACA 2006-2, the collateral management fees on ACA 2006-2 dropped dramatically—from $361,000 per month to $164,000 per month—when ACA was replaced by Solidus.

74. In addition, ACA, as the owner of 10% of the equity (Preference Shares) of ACA 2006-2, received cash distributions from the CDO, which again enured to Bear Stearns' benefit through its 35% ownership of ACA. These distributions were heavily weighted in favor of Preference Shares over senior notes. Thus, distributions to Preference Shares through June 25, 2007 totaled $2.5 million, or 6% of the notional Preference Share closing balance of $42 million. By contrast, distributions to all senior note classes A1LA through B1L totaled only $2.9 million,

or a mere 0.4% of the notes' notional closing balance of $708 million. Moreover, the final distribution to Preference Shares, totaling $1.8 million, was declared on June 25, 2007 but was not actually paid until July 10, 2007, after ACA 2006-2 had begun to fail collateral quality tests.

75. Similarly, for its putative management of Libertas II, Strategos received a senior management fee of 15 bps, which again was substantial for a static deal. Thus, Strategos' fees on Libertas II totaled $1,289,053. Moreover, most of these fees were paid long after Libertas II began to fail. Thus, $1,107,764 of these fees (86%) were paid after Libertas II began failing collateral quality tests on August 8, 2007, and $328,839 (26%) were paid after Libertas II suffered an Event of Default on May 16, 2008.

76. In addition, Strategos' parent, Cohen, was selected as the placement agent for Libertas II, for which it received a substantial up-front fee.

77. Most significantly, according to the Libertas II Offering Circular, Strategos or Cohen had a controlling interest in the Preference Shares of Libertas II at closing. Thus, Strategos or Cohen benefited from the fact that cash distributions by Libertas II, like those of ACA 2006-2, were heavily weighted in favor of Preference Shares over senior notes. Similarly, Bear Stearns and Cohen benefited from the fact that cash distributions by Libertas II were also heavily weighted in favor of Class X notes, the proceeds of which were used to pay issuance and placement fees paid to Bear Stearns and Cohen respectively. Preference Shares received total distributions of $3,475,876—i.e., 17% of their notional value at closing of $20,250,000. For their part, Class X notes received total principal and interest distributions of $3,028,423; of this total, principal distributions amounted to $2,568,154 or 42.8% of the notes' notional closing value of $6 million. By contrast, Libertas II senior notes—including Classes A-1 through E—received principal distributions of $3,437,121, a mere 0.7% of their aggregate notional value at

closing of $473,000,000. Moreover, $3,201,302 (92%) of the distributions paid to Preference Shares were paid after Libertas II began failing collateral quality tests. Similarly, $2,644,684 (87%) of the distributions paid to Class X notes were paid after Libertas II began failing collateral quality tests; and $1,172,960 (39%) of the principal and interest distributions paid to Class X notes were paid after Libertas II suffered an Event of Default.

A. At Bear Stearns' Direction, the Portfolios of ACA 2006-2 and Libertas II Were Stocked with Toxic Assets from Bear Stearns' Books

78. At Bear Stearns' direction, ACA agreed to include at least $206 million of RMBS owned by Bear Stearns in the portfolio of ACA 2006-2 (27% of the total portfolio)—including both RMBS underwritten by Bear Stearns ($81 million) and RMBS held in the Cioffi portfolio ($125 million). At the time the deal was entered into, there was no way for CIFG to know the source of the assets that were offloaded from the Cioffi portfolio, since the portfolio was not publicly available at that time. These Bear Stearns-related assets were by far the most toxic assets in the ACA 2006-2 portfolio. For example, nine of the first eleven RMBS in the portfolio to default came from Bear Stearns' inventory. Five of these RMBS contained loans originated by AHM, and as Bear Stearns itself acknowledged, by this time more than 60% of AHM's loans were more than 30 days delinquent. Moreover, by November 30, 2008, 89% of the Bear Stearns collateral in the portfolio had defaulted (98% of the Bear Stearns-underwritten RMBS and 84% of the RMBS sourced from the Cioffi Funds), compared to only 52% of the non-Bear Stearns collateral—in other words, 42% more of the Bear Stearns-related collateral had defaulted. In addition, the non-Bear Stearns assets in the portfolio lasted on average 1.69 years before default, compared to 1.32 years for the Bear Stearns assets (1.39 years for Bear Stearns-underwritten RMBS and 1.13 years for RMBS sourced from the Cioffi Funds). Thus, the average life before

default of the non-Bear Stearns collateral in the portfolio was 28% longer than that of the Bear Stearns collateral.

79. Similarly, at Bear Stearns' direction, Strategos agreed to include at least $80 million of toxic RMBS from Bear Stearns' inventory—both Bear Stearns-underwritten RMBS and RMBS from the Cioffi Funds—in the Libertas II portfolio, representing 16% of the total portfolio. Again, there was no way for CIFG to know the source of the assets that had come from the Cioffi portfolio, and again, these Bear Stearns-related assets were the most toxic assets in the portfolio. The non-Bear Stearns assets in the portfolio lasted on average 1.56 years before default, compared to 1.18 years for the Bear Stearns assets (1.38 years for Bear Stearns-underwritten RMBS and 0.91 years for RMBS sourced from the Cioffi Funds). Thus, the average life before default of the non-Bear Stearns collateral in the Libertas II portfolio was 33% longer than that of the Bear Stearns collateral.

80. In addition, at Bear Stearns' behest, ACA added more toxic Bear Stearns collateral to the ACA 2006-2 portfolio *after* CIFG had been provided with the putatively 95%-ramped portfolio on October 16, 2006. In fact, after that date, ACA actually *removed* $25 million of the collateral that had been shown to CIFG and then added $65 million of collateral, of which $20.3 million—*i.e.*, 30%—were Bear Stearns assets (whereas only $2 million of the collateral that had been removed were Bear Stearns assets). Thus, after these additions, the proportion of Bear Stearns collateral in the portfolio was significantly higher than in the portfolio CIFG had been shown. Moreover, the Bear Stearns added collateral was significantly more toxic than the other added collateral: the average life before default of the added non-Bear Stearns collateral (1.29 years) was 18% longer than that of the added Bear Stearns collateral (1.14 years).

81. Similarly, also at Bear Stearns' behest, Strategos added more toxic Bear Stearns collateral to the Libertas II portfolio after CIFG had been provided with the 85%-ramped portfolio on January 5, 2007. Of the $77.2 million of collateral added to the portfolio after that date, $19.6 million—*i.e.*, 25%—were Bear Stearns assets. Thus, again, after these additions, the proportion of Bear Stearns collateral in the portfolio was significantly higher than in the portfolio CIFG had been shown. And again, the Bear Stearns later-added collateral was significantly more toxic than the other added collateral: the average life before default of the added non-Bear Stearns collateral (1.63 years) was 10% longer than that of the added Bear Stearns collateral (1.49 years).

82. As a result of the huge volume of toxic RMBS that Bear Stearns directed its collateral managers to include in the portfolios of ACA 2006-2 and Libertas II, both of these CDOs failed extraordinarily quickly. ACA 2006-2 suffered an Event of Default only 0.93 years after closing, and Libertas II suffered one only 1.25 years after closing. These failures were much more rapid than those of comparable CDOs created during this period. Even the notorious ABACUS CDO, which was built to fail by Goldman and Paulson, lasted 1.25 years before defaulting.

83. Most tellingly, there was a remarkably high overlap between the portfolios of ACA 2006-2 and the portfolios of other CDOs which were managed by ACA and Strategos and were likewise stocked with toxic assets at the behest of net short investors who deliberately built the CDOs to fail. Thus, 44% of the issues referenced in ACA 2006-2 were also referenced in Aquarius, while 38% were referenced in ABACUS, both of which were managed by ACA but were in fact controlled by net short investors—Magnetar for Aquarius and Paulson (assisted by Goldman) for ABACUS. Considering that ACA 2006-2 only referenced 126 unique issues out

of a potential universe of more than 1,000 issues, this overlap is remarkable. The overlap between subprime issues is even more remarkable. 51% of the subprime issues referenced in ACA 2006-2 were also referenced in Aquarius, while 48% were referenced in ABACUS. Thus, there was a very high overlap between ACA 2006-2 and the portfolios of two other ACA-managed CDOs which were unquestionably built to fail, reinforcing the inference that ACA 2006-2 was also built to fail.

84. Similarly, a staggering 71% of the issues in the Libertas II portfolio were also included in the portfolio of Scorpius, a deal for which Strategos acted as collateral manager but which was in fact controlled by Magnetar. Further, approximately one-third of the Libertas II portfolio was also included in two other Magnetar deals for which Strategos did not act as collateral manager but which Magnetar also built to fail and shorted heavily—Norma and Auriga. In addition, there was a huge overlap between the portfolio of Libertas II and those of Libertas III (66%) and Libertas IV (78%), both of which, although not Magnetar deals, were nevertheless heavily shorted by Magnetar, indicating that Magnetar considered them well stocked with toxic assets. Thus, like ACA 2006-2, there was a very high overlap between Libertas II and the portfolios of CDOs, one of them managed by Strategos, which were unquestionably built to fail, reinforcing the inference that Libertas II was also built to fail.

85. There is no way all of these overlaps happened by chance—especially given that there were well over *1,000* RMBS issued in 2005-2007 from which the RMBS in the ACA 2006-2 and Libertas II portfolios could have been selected. The overlaps with numerous Magnetar deals are particularly significant. Magnetar created 26 CDOs, each named after a different constellation (the "Constellation CDOs"), pursuant to what it described as a "hedged equity strategy." This strategy involved purchasing the equity in each of its CDOs and also taking out a

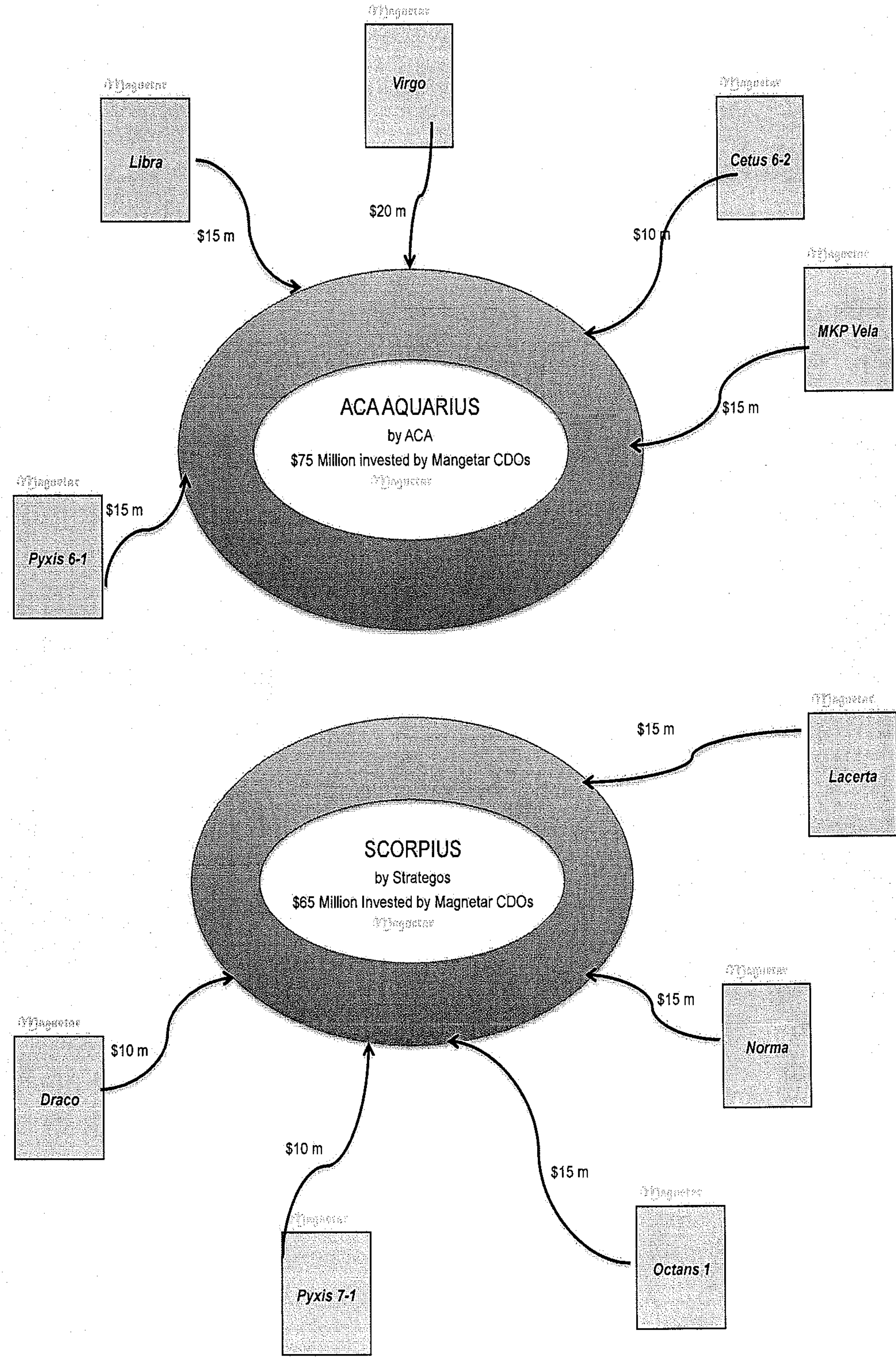
much larger short position against the CDO, and using its control over portfolio selection for the CDO to ensure that it was built to fail and that Magnetar would make substantial profits from its net short position. As Magnetar itself confirmed in a letter to its investors dated April 19, 2010, its average short position on each of the Constellation CDOs was 7% of the aggregate initial value of the CDO's portfolios—typically five to six times the size of its equity position in these CDOs, thereby confirming that Magnetar had a much greater interest in seeing the CDOs fail than in having them succeed.

86. To ensure that its CDOs would fail, Magnetar directed its collateral managers to invest in a set of preferred, high-risk assets which it believed were likely to fail, and it further instructed most of them to invest heavily in other Magnetar CDOs, which were also built to fail. The statistical probability of the interconnections and portfolio overlaps between all 26 of Magnetar's CDOs having occurred by chance (*i.e.*, of Magnetar's collateral managers having selected the collateral for these CDOs independently) is less than one in a billion.

87. At Magnetar's behest, ACA and Strategos selected many of Magnetar's preferred assets for Aquarius and Scorpius respectively. This resulted in an undisclosed, remarkably high correlation between the assets selected for Aquarius and Scorpius and the assets held by other Constellation CDOs. For instance, of 183 unique CUSIPs in the Aquarius portfolio, fully 96 CUSIPs (or 54%) were included in at least five other Magnetar CDOs, while 43 CUSIPs (or 24%) were included in at least ten other Magnetar CDOs. Similarly, of 177 unique CUSIPs in the Scorpius Portfolio, fully 88 CUSIPs (or 51%) were included in at least five other Magnetar CDOs, while 44 CUSIPs (or 26%) were included in at least ten other Magnetar CDOs. Again there is no way this happened by chance, given that there were well over 1,000 RMBS from which the RMBS in the Aquarius and Scorpius portfolios could have been selected.

88. To further ensure that its CDOs failed, Magnetar also directed many of its collateral managers to invest in other Magnetar CDOs, which were also built to fail. At Magnetar's behest, five Constellation CDOs (Pyxis 2006-1, Libra, Virgo, Cetus 2006-2 and MKP Vela) invested a total of $75 million in Aquarius, and five other Constellation CDOs (Draco, Pyxis 2007-1, Octans 1, Norma and Lacerta) invested a total of $65 million in Scorpius. These investments confirm that Magnetar regarded Aquarius and Scorpius as sufficiently toxic to materially advance its shorting strategy. These investments are set forth in the graphic below:

Constellation CDOs Investments in ACA Aquarius and Scorpius



Overlaps

1. 96 CUSIPs in ACA Aquarius are repeated 5 or more time in all other Magnetar CDOs; 43 CUSIPs are repeated 10 or more times.
2. 88 CUSIPs in Scorpius are repeated 5 or more times in all other Magnetar CDOs; 44 CUSIPs are repeated 10 or more times.
3. Nearly 24% of the RMBS issues represented in Scorpius are also represented in Aquarius.

89. Magnetar's control of collateral selection for its CDOs and its adverse collateral selection are further confirmed by numerous documents which have come to light in recent lawsuits against Magnetar, its structurers, and collateral managers brought by regulators and investors with respect to Pyxis 2006-1, Pyxis 2007-1, Norma, Squared CDO, Orion 2006-1, and Carina CDO, Ltd. A sampling of these documents show that:

- Magnetar regarded its CDOs as "separate account mandates," or "structured separate accounts," for which the collateral manager was accountable to Magnetar. [Orion 2006-2]

- Magnetar told one collateral manager that it would "have to play ball." [Pyxis 2006-1]

- Magnetar made a "behind the scenes" arrangement with the structurers and collateral managers on two of its deals that gave it "veto rights over any warehouse asset." [Pyxis 2006-1]

- Magnetar told a structurer that it didn't want the collateral manager "buying CDO's without us knowing about it." [Pyxis 2006-1]

- Magnetar told that collateral manager: "We are going to source the CDO exposure synthetically." [Pyxis 2006-1]

- A structurer sent a collateral manager a target portfolio stating: "These are the names and levels agreed with Magnetar." [Squared]

- A structurer stated: "Apparently NIR [the collateral manager]allowed Magnetar to do some trading for their portfolio (in the area of 600MM). This accounted for a large chunk of trading that NIR originally didn't recognize." [Norma]

- As a result, another structurer asked: "Dumb question. Is Magnetar allowed to trade for NIR?" [Norma]

- Magnetar stated: "I definitely want to approve any CDO's that go in the deal." [Norma]

- Magnetar told its collateral manager on another deal: "I'd like to establish a bit more of a dialogue between us. Discuss ramping strategy, talk about each list as it goes out, plan for non-sub/mid-prime sectors, market conditions, that sort of thing. Just talk briefly a few times a week." [Carina]

- Magnetar told a collateral manager: "As we did last time, I would like to strategize and discuss names for the CDO bucket before we execute any trades. ... I will be taking the other side of this first trade as approved such that I am effectively pairing off its risk . . . ." [Carina]

- Magnetar stated that it regarded its equity position on one CDO as "basically nothing" and that it was "just doing it [taking the equity position] . . . to buy some protection." [Squared]

- In an email to a collateral manager, Magnetar "highlighted the names which it had interest in shorting into the deal." [Squared]

- Magnetar told a collateral manager: "We will buy protection from the deal on agreed upon names and that will fill the bucket." [Orion 2006-1]

- Magnetar told a structurer: "I would like them to sell me protection on ... any of my deals of course." [Class V]

90. Given the compelling evidence that Magnetar controlled collateral selection for all of its CDOs, and built them to fail so that it could profit from its significant net short position on the CDOs, it is inconceivable that it would not also have controlled collateral selection on Aquarius and Scorpius and likewise built them to fail.

91. Thus, not only is it clear that both ACA and Strategos were willing to accept direction on collateral selection for the CDOs they were managing, but it is also clear that any CDOs whose portfolios substantially overlapped with Magnetar deals (as the ACA 2006-2 portfolio did with Aquarius, and as the Libertas II portfolio did with Scorpius, Norma, and Auriga) were highly likely to have been built to fail.

B. Bear Stearns Shorted ACA 2006-2 and Libertas II

92. Moreover, Bear Stearns did not merely seek to reduce its RMBS exposure by dumping toxic assets into ACA 2006-2 and Libertas II. Like Magnetar and Paulson, it also shorted these assets in an attempt to hedge some of its huge remaining exposure on its RMBS portfolio. This is confirmed, first, by the fact that the portfolios of ACA 2006-2 and Libertas II were demonstrably built to fail—and were thus ideally constructed for the benefit of short rather

than long investors. It is also confirmed by the fact that $150 million (fully 20%) of the ACA 2006-2 portfolio consisted of a disguised synthetic investment (*i.e.*, a CDS referencing an asset, rather than a direct acquisition of the asset) in the ABX 6-1 BBB- Index of low-rated RMBS. This was a natural extension of large short positions Bear Stearns had begun taking against the ABX Index as early as February 2006. For example, in February 2006 Bear Stearns shorted $25 million of the ABX BBB Index into the Cioffi Funds, and in May 2006—just a month before the disguised investment by ACA 2006-2—Bear Stearns shorted $25 million of the ABX 6-1 BBB-Index into the Cioffi Funds.

93. The disguised synthetic investment by ACA 2006-2 was made by way of 15 separate $10 million CDS referencing 15 individual components of the ABX 6-1 BBB- Index, rather than a single CDS directly referencing the Index itself. It is clear that these 15 separate CDS were coordinated and thus comprised, in effect, a single investment, because: (1) they were the only synthetic trades in the entire ACA 2006-2 portfolio (*i.e.*, the only trades made by way of CDS rather than direct purchases of RMBS); (2) all 15 trades were executed on the same day (June 29, 2006); and (3) all 15 trades were executed at precisely the same premium (243 bps), despite the fact that CDS premiums at that time were extremely volatile. (Among other things, therefore, these trades clearly breached Bear Stearns' and ACA's representation at the September 22, 2006 due diligence meeting that ACA would get bids from 8-12 dealers for each of its CDS investments, since it is inconceivable that bids from 8-12 dealers would have resulted in identical premiums for all 15 CDS.) The investment had to be disguised in this way because there was a 1.5% portfolio concentration limit on any investment by ACA 2006-2 in the ABX 6-1 BBB-Index, which was necessary given the Index's low rating and correspondingly high risk. The disguise was very effective: the CIFG employees who performed due diligence on the ACA

2006-2 portfolio had no idea that these trades were coordinated or even that they were all components of the ABX 6-1 BBB- Index, nor did they have any reason to suspect this.

94. Given that Bear Stearns had been taking large short positions against the ABX 6-1 Index since at least February 2006, the most plausible explanation for this disguised investment is that it was designed to provide Bear Stearns with the opportunity to take the short side of the CDS, and thus to make another bet against the ABX 6-1 BBB- Index of $150 million, at ACA 2006-2's expense. At a minimum, it was clearly designed to allow a single short counterparty to make such a bet at ACA 2006-2's expense, and was thus plainly made at the direction of an entity other than ACA, contrary to Bear Stearns' representations that ACA would independently select the collateral for ACA 2006-2.

VIII. Bear Stearns Profited from Its Fraud

95. By controlling collateral selection for ACA 2006-2 and Libertas II, Bear Stearns was able both to offload large numbers of toxic assets and to profit from short positions it took against these CDOs. In addition, Bear Stearns received a higher than normal intermediation fee on Libertas II of 3 bps (and 6.25 bps for ABX Index securities).

IX. CIFG Lost Over $100 Million as a Result of Bear Stearns' Fraud

96. As early as July 3, 2007, only seven months after closing, ACA 2006-2 began to fail collateral quality tests. On November 5, 2007, just 11 months after closing, ACA 2006-2 suffered an Event of Default. Also on that date, Moody's downgraded the credit rating of the ACA 2006-2 A-1LA tranche (the tranche referenced by the ACA 2006-2 Swap and insured by the ACA 2006-2 Guaranty) from Aaa to Baa3. Ten days later, on November 15, 2007, Moody's further downgraded this tranche to B3. Finally, on June 4, 2008, Moody's downgraded this tranche from B3 to Ca.

97. As early as August 8, 2007, fewer than six months from closing, Libertas II began failing collateral quality tests. On May 16, 2008, only 15 months after closing, Libertas II suffered an Event of Default. On March 26, 2008, Moody's downgraded the credit rating of the Libertas II A-1 tranche (the tranche referenced by the Libertas II Swap and insured by the Libertas II Guaranty) from Aaa to Baa3, and on May 18, 2008 it further downgraded this tranche to Caa2.

98. Had CIFG been aware that ACA and Strategos were not selecting the collateral for ACA 2006-2 and Libertas II, as Bear Stearns had represented, but were in fact taking direction from Bear Stearns with respect to collateral selection, and that Bear Stearns' interests in the CDOs were adverse to the interests of long investors, CIFG would never have entered into the Guaranties. CIFG was not aware of these facts, and could not have learned them through the exercise of reasonable diligence. As a result of Bear Stearns' misrepresentations and fraud, CIFG was obliged to pay more than $100 million to discharge its liabilities under the Guaranties when ACA 2006-2 and Libertas II failed.

CAUSES OF ACTION

FIRST CAUSE OF ACTION: MATERIAL MISREPRESENTATION IN INDUCEMENT OF INSURANCE CONTRACT

99. CIFG repeats and realleges the allegations set forth above as though fully set forth herein.

100. This is a claim for material misrepresentation in the inducement of an insurance contract, brought under common law as informed by New York Insurance Law Section 3105. This claim is brought against Bear Stearns relating to material affirmative misrepresentations and material omissions that it made to induce CIFG to provide financial guaranty insurance on the ACA 2006-2 and Libertas II Swaps by way of the ACA 2006-2 and Libertas II Guaranties.

101. Bear Stearns made material misrepresentations of fact to induce CIFG to enter into the ACA 2006-2 and Libertas II Guaranties. Bear Stearns represented, among other things, that ACA and Strategos would select the assets to be included in the portfolios for ACA 2006-2 and Libertas II, respectively, acting as diligent and independent collateral managers in the interests of long investors. These representations were made, among other things, in the Pitchbooks for each deal, the Offering Circulars for each deal, and in numerous other written and oral representations by ACA and Strategos in the course of due diligence on each of the deals.

102. Bear Stearns also omitted to disclose material facts necessary to make the statements it had made not materially misleading. Among other things, Bear Stearns failed to disclose that:

- ACA and Strategos did not select the assets for ACA 2006-2 and Libertas II acting diligently, independently and in good faith in the interests of long investors, but rather at the behest of and under the direction of Bear Stearns to whom they ceded control over the selection of assets;

- Bear Stearns stocked the portfolios of ACA 2006-2 and Libertas II with toxic assets to clear them off its own books and to provide it with an opportunity to hedge its remaining RMBS exposures, contrary to the interests of CIFG;

- The asset selection procedures for ACA 2006-2 and Libertas II were based on a process that emphasized weaker assets over stronger ones; and

- All these actions materially increased the risk that CIFG would have to make payments on the ACA 2006-2 and Libertas II Guaranties.

103. All of this information was known to Bear Stearns but not known or readily available to CIFG. CIFG did not know, and could not have reasonably discovered, that the selection process had been corrupted by Bear Stearns.

104. Bear Stearns' misstatements and omissions were material to CIFG's decision to enter into the ACA 2006-2 and Libertas II Guaranties since they bore directly on the

performance of the ACA 2006-2 and Libertas II portfolios, the likelihood of a Credit Event occurring under the ACA 2006-2 and Libertas II Guaranties, and the possibility that the ACA 2006-2 and Libertas II notes would default, leaving CIFG to bear any losses.

105. CIFG reasonably relied on Bear Stearns' misstatements and omissions in entering into the ACA 2006-2 and Libertas II Guaranties. Without these material misstatements and omissions, CIFG would not have entered into the ACA 2006-2 and Libertas II Guaranties.

106. As a direct, proximate, and foreseeable result of Bear Stearns' conduct, CIFG has suffered harm. Accordingly, CIFG should be restored to the status quo ante and CIFG should be awarded damages incurred as a result of its entry into the ACA 2006-2 and Libertas II Guaranties in an amount to be determined at trial.

107. This Count is brought within the time permitted by law.

**SECOND CAUSE OF ACTION:
FRAUD**

108. CIFG repeats and realleges the allegations set forth above as though fully set forth herein.

109. This is a claim for fraud brought against Bear Stearns relating to affirmative misrepresentations and material omissions it made to induce CIFG to enter into the ACA 2006-2 and Libertas II Guaranties.

110. Bear Stearns made material misrepresentations of fact in connection with CIFG's entry into the ACA 2006-2 and Libertas II Guaranties. Bear Stearns represented, among other things, that ACA and Strategos would select the assets to be included in the portfolios for ACA 2006-2 and Libertas II, respectively, acting as diligent and independent collateral managers in the interests of long investors. These representations were made, among other things, in the

Pitchbooks for each deal, the Offering Circulars for each deal, and in numerous other written and oral representations by ACA and Strategos in the course of due diligence on each of the deals.

111. Bear Stearns also omitted to disclose material facts necessary to make the statements it had made not materially misleading. Among other things, Bear Stearns knowingly or recklessly failed to disclose that:

- ACA and Strategos did not select the assets for ACA 2006-2 and Libertas II acting diligently, independently, and in good faith in the interests of long investors, but rather at the behest of and under the direction of Bear Stearns to whom it ceded control over the selection of assets;

- Bear Stearns stocked the portfolios of ACA 2006-2 and Libertas II with toxic assets to clear them off its own books and to provide it with an opportunity to hedge its remaining RMBS exposures, contrary to the interests of CIFG;

- The asset selection procedures for ACA 2006-2 and Libertas II were based on a process that emphasized weaker assets over stronger ones; and

- All these actions materially increased the risk that CIFG would have to make payments on the ACA 2006-2 and Libertas II Guaranties.

112. All of this information was known to Bear Stearns but not known or readily available to CIFG. CIFG did not know, and could not have reasonably discovered, that the selection process had been corrupted by Bear Stearns. Bear Stearns further knew that their representations were false and misleading, and made the representations with the intent and expectation that CIFG would rely on them in agreeing to enter into the ACA 2006-2 and Libertas II Guaranties.

113. Bear Stearns' misstatements and omissions were material to CIFG's decision to enter into the ACA 2006-2 and Libertas Guaranties since they bore directly on the performance of the ACA 2006-2 and Libertas II portfolios, the likelihood of a Credit Event occurring under

the ACA 2006-2 and Libertas II Guaranties, and the possibility that the ACA 2006-2 and Libertas II notes would default, leaving CIFG to bear any losses.

114. CIFG reasonably relied on Bear Stearns' misstatements and omissions in entering into the ACA 2006-2 and Libertas II Guaranties. Without these material misstatements and omissions, CIFG would not have entered into the ACA 2006-2 and Libertas II Guaranties.

115. Bear Stearns' conduct, as alleged herein, was willful, malicious, reckless, and without regard to CIFG's interests.

116. As a direct, proximate, and foreseeable result of Bear Stearns' conduct, CIFG has suffered harm. Accordingly, CIFG should be restored to the status quo ante and CIFG should be awarded damages incurred as a result of its entry into the ACA 2006-2 and Libertas II Guaranties in an amount to be determined at trial. As a result of Bear Stearns' conduct, CIFG is also entitled to punitive damages.

117. This Count is brought within the time permitted by law.

Prayer for Relief

WHEREFORE, CIFG requests the Court enter judgment:

(a) awarding CIFG damages to restore it to the status quo ante;

(b) awarding CIFG compensatory damages in amounts to be determined at trial, together with pre-judgment interest at the maximum rate allowable by law;

(c) awarding CIFG punitive damages in an amount to be determined at trial;

(d) awarding CIFG reasonable costs and expenses incurred in this action, including, to the extent applicable, counsel fees; and

(e) such other relief as the Court deems just and proper.

Dated: November 26, 2012
New York, New York

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