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

MBIA Insurance Corporation and LaCrosse Financial Products, LLC, Plaintiffs, -against- Merrill Lynch, Pierce, Fenner and Smith Inc., and Merrill Lynch International, Defendants.	Index No. 09-601324 APR 30 2009 **SUMMONS** NOT COMPARED WITH COPY FILED

TO: MERRILL LYNCH, PIERCE, FENNER AND SMITH INC.
Merrill Lynch, Pierce, Fenner & Smith Incorporated
Attn: Litigation Department
222 Broadway, 16th Floor
New York, NY 10038

MERRILL LYNCH INTERNATIONAL
Merrill Lynch, Pierce, Fenner & Smith Incorporated
Attn: Litigation Department
222 Broadway, 16th Floor
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YOU ARE HEREBY SUMMONED to answer the complaint in this action and to serve a copy of your answer on Plaintiffs' attorneys within twenty (20) days after the service of this summons, exclusive of the day of service (or within thirty (30) days after the service is complete if this summons is not personally delivered to you within the State of New York). In case of your failure to appear, judgment will be taken against you by default for the relief demanded in the complaint.

Plaintiffs designate New York County as the place of trial. The bases of the venue designated are that: (a) under contracts at issue in this action, the parties have consented

to this Court's jurisdiction and venue, and the contracts provide that they shall be governed by New York law, and (b) Defendants have offices in this County and many of the wrongful acts alleged in the Complaint occurred in this County.

DATED: New York, New York
April 30, 2009

Respectfully submitted,

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SUPREME COURT OF THE STATE OF NEW YORK
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MBIA Insurance Corporation and LaCrosse Financial Products, LLC, Plaintiffs, -against- Merrill Lynch, Pierce, Fenner and Smith Inc., and Merrill Lynch International, Defendants.	Index No. **COMPLAINT**

Plaintiffs MBIA Insurance Corporation and LaCrosse Financial Products, LLC ("LaCrosse" and collectively "MBIA"), by their attorneys Quinn Emanuel Urquhart Oliver & Hedges, LLP, for their complaint against Defendants Merrill Lynch, Pierce, Fenner and Smith Inc. and Merrill Lynch International (collectively "Merrill Lynch"), allege the following:

NATURE OF THE ACTION

1. This action arises out of the fraudulent conduct of Merrill Lynch in connection with a series of structured product transactions that it arranged and marketed over the period from July 2006 through March 2007. As represented by Merrill Lynch, the transactions involved providing credit protection for (1) highly conservative super-senior (above AAA credit quality) and senior debt instruments that (2) had substantial structural protection from subordinate interests, including senior tranches, bearing first loss and additional loss exposures, and (3) were backed primarily by "high grade" (credit quality at "A-" or above) debt collateral valued at or near par. Based upon Merrill Lynch's representations, and its professed expertise and knowledge as a broker-dealer and underwriter of the relevant securities, MBIA wrote $5.7 billion of credit default protection and was willing to accept extremely low premium payments

averaging less than 8 basis points (0.08%) annually in view of the expected high quality of these transactions.

2. In fact, as of the respective closing date of each transaction, the interests arranged, marketed, and sold by Merrill Lynch did not constitute super-senior/senior securities backed by "high grade" collateral, but instead represented interests (1) with credit quality far below AAA, (2) with little or no subordination protection, and even day-one expected losses to principal, and (3) backed by collateral not only below "high grade" quality but even below investment grade. As a direct result of Merrill Lynch's fraud and breaches of contract, MBIA now faces expected losses presently estimated in excess of several hundred million dollars.

3. The transactions at issue were all in the form of credit default swaps (the "CDS Contracts") written against tranches of collateralized debt obligations ("CDOs"). A credit default swap is a contract in which one party (here, MBIA) insures or "wraps" the risk of loss or other defined credit events on a reference obligation in exchange for premium payments by the other party during the term of the swap. Based upon Merrill Lynch's representations, LaCrosse entered into CDS Contracts on the CDOs with Merrill Lynch and other counterparties, and MBIA issued insurance policies that guaranteed LaCrosse's ability to pay any contingent liabilities arising under the CDS Contracts.

4. Merrill Lynch structured the CDS Contracts to insure the risk of loss on the supposed super-senior and senior tranches of four CDOs that Merrill Lynch itself had arranged. A CDO is a special purpose vehicle for the re-securitization of debt securities, which a CDO owns as collateral. A CDO issues its own debt and equity securities (or "tranches"), which have defined participation interests in the cash flows from the CDO collateral, according to the seniority of the tranches within the CDO structure.

5. The CDOs at issue ("ML-series CDOs") were all highly complex structures that owned multiple types of other debt securities, including residential and commercial mortgage-backed securities ("RMBS" and "CMBS") as well as tranches of other CDOs—some of which, in turn, contained tranches of still other CDOs. This CDO-squared and CDO-cubed structure meant that the performance of each ML-series CDO turned on the performance of literally thousands of underlying debt securities.

6. In the period leading up to 2006, Merrill Lynch had transformed itself from a lower-ranked CDO arranger into the so-called "Wal-Mart" of CDOs, originating over $44 billion of RMBS CDOs in 2006 alone, a prodigious output resulting in at least $700 million in fee income. But by September 2006, Merrill Lynch carried on its books inventory including at least $17 billion in RMBS CDO securities, as well as an additional $18 billion in mortgage-backed bonds, and a further $14 billion in subprime loans.

7. As the U.S. housing market began showing initial signs of deterioration in late 2006, Merrill Lynch faced a dilemma. Based on its specific knowledge of the declining performance of the underlying loans in the RMBS and CDO positions on its own balance sheet, Merrill Lynch knew that its RMBS and CDO holdings had lost value and faced increasing risks of default well in excess of historical rates of default. Merrill Lynch further knew that it was only a matter of time before credit agency ratings on the RMBS and CDOs took into account the underlying loan problems and their impact on the structured products.

8. To solve this problem, Merrill Lynch resorted to a scheme of repackaging its own flagging RMBS and CDO assets into new generations of CDOs. In particular, the complex CDO-squared and CDO-cubed structures employed by Merrill Lynch served to disguise and defer any recognition of losses in the underlying collateral. Merrill Lynch knew, based on

the published methodologies of Standard & Poor's ("S&P") and Moody's Investor Service ("Moody's"), as well as from its extensive collaboration with the rating agencies in its capacity as an arranger and broker-dealer, that the rating agencies would not look through the RMBS and CDOs to the performance of the underlying loans in order to rate the new CDO transactions—and, therefore, that the resulting credit ratings would not accurately reflect the true characteristics of the securities.

9. Accordingly, in two related strategies that came to be known internally as "de-risking" and "mitigation," Merrill Lynch flipped its losing positions to investors and credit default swap counterparties by re-securitizing the RMBS and RMBS CDOs into new CDOs, including the new ML-series CDOs. Merrill Lynch's "de-risking" consisted of selling off either the new CDO tranches or the credit exposure on the tranches through swaps covering the risk of default. This practice was exposed by the Wall Street Journal in April 2008:

> Merrill set out to reduce its exposure, in an effort referred to innocuously as "de-risking." It could have sold off billions of dollars' worth of mortgage-backed bonds that it had stockpiled with the intention of packaging them into more CDOs. But with the market for such bonds slipping, Merrill would have had to record losses of $1.5 billion to $3 billion on the bonds.... Instead, Merrill tried a different strategy: quickly turn the bonds into more CDOs.... As the CDO business slid, Merrill's top managers embarked on a new plan, referred to as the "mitigation strategy." The aim was to find ways to hedge exposure through deals with bond insurers. This would reduce the size of write-downs Merrill would otherwise have to take.

Over the course of a year, between 2006 and 2007, Merrill Lynch thus approached MBIA and other monoline insurers to write protection against the risk of default on the senior tranches of its repackaged CDOs and thereby "mitigate" its own exposures.

10. As of the 2006-2007 period, the buy-side industry standard approach to evaluating senior debt tranches of complex and illiquid CDOs like the ML-series CDOs was (1) due diligence of the expertise and integrity of the arranger and collateral manager, and

(2) cash-flow ratings-based modeling and stress testing of the CDO tranches and collateral—with credit quality the paramount input. In particular, as Merrill Lynch knew, it was not customary, and would have been very unusual, for any buyer or any credit protection provider at the super-senior level to value complex CDOs by assessing the thousands of underlying securities and the tens or hundreds of thousands of underlying loans, in order to verify whether the arranger's representations of credit quality were truthful.

11. Merrill Lynch further knew specifically that MBIA, a monoline insurer that stood to earn annual premiums of less than one-thousandth its nominal exposure, (1) did not and could not perform a cost-effective loan-level valuation analysis of the ML-series CDOs, and (2) would instead rely on Merrill Lynch's express representations that the CDS Contracts were written against super-senior and senior tranches backed by "high grade" collateral.

12. Merrill Lynch specifically marketed the CDS Contracts to MBIA based on its representations of the high credit quality of the ML-series CDO tranches and collateral. The primary thrust of Merrill Lynch's marketing materials concerned the supposed AAA credit quality of the wrapped tranches and the "high grade" quality of the collateral (rated "A-" or better), as well as related indicia of creditworthiness, including superior levels of subordination to the tranches. Merrill Lynch's marketing materials also concerned performance metrics—such as likelihood of default, recovery rates, prepayment rates, and rating transitions—keyed off ratings and credit quality. As a self-proclaimed leader in structured finance CDOs, with a substantial relationship with MBIA, and as the broker-dealer and arranger of the transactions, Merrill Lynch knew and intended that MBIA would rely upon its stated expertise, knowledge, and representations regarding the ratings and credit quality of the underlying collateral as a fundamental input to MBIA's own risk assessment.

13. But Merrill Lynch's representations as to the ratings, super-senior/senior quality, and subordination of the ML-series CDOs, and the ratings and "high grade" nature of the ML-series CDO collateral, were all egregiously false and misleading when made. Contrary to Merrill Lynch's representations, the transactions were backed by inferior and below-investment grade collateral. Consequently, the CDS Contracts were written against tranches of mezzanine—not super-senior—credit quality with inadequate subordination and even embedded losses. Further, as Merrill Lynch intended with its "de-risking" and loss "mitigation" strategies, the ML-series CDO collateral with the lowest value and most compromised credit quality were the very securities sourced from Merrill Lynch's own unsold inventory of CDOs it had itself structured.

14. Merrill Lynch, as the arranger, broker-dealer, and warehouse provider for each of the CDOs at issue, as well as the operator of its own mortgage origination and servicing business, had knowledge and expertise significantly superior to MBIA concerning the credit quality of the ML-series CDOs. As Merrill Lynch knew, MBIA's due diligence consisted primarily of ratings-based modeling and analysis of the expertise and integrity of the arranger and collateral manager. By contrast, Merrill Lynch knew that it had procured the ratings on the basis of inadequate information—including its nondisclosure of the problems in loan-level performance—and that the ratings did not fairly reflect the actual credit quality of either the CDO tranches or the collateral. For its internal purposes, unlike its marketing, Merrill Lynch thus looked to the underlying performance data of the tens or hundreds of thousands of loans comprising the RMBS and to the performance of the collateral of the inner CDO securitizations of the ML-series CDOs.

15. This loan-level data, in the period from late 2006 through 2007, provided Merrill Lynch with real-time information concerning the declining credit quality of the collateral

in the ML-series CDOs, well in advance of downgrades by the rating agencies. Merrill Lynch did not disclose this superior knowledge to MBIA but instead marketed the CDS Contracts based on ratings, and related indicia of credit quality, that it knew to be false and misleading. Merrill Lynch did not disclose to MBIA that it knew the ratings were false or that it used alternative indicia of credit quality for its own books. In effect, Merrill Lynch sold the deals to MBIA based on one set of values—the ratings of the wrapped tranches and collateral—while marking its own books based on materially different valuations derived from its loan-level performance data. Merrill Lynch thus fraudulently induced MBIA to enter into the CDS Contracts based upon materially false and misleading representations as to the ML-series CDO tranches and collateral.

16. At the same time, Merrill Lynch committed insurance fraud under the New York Insurance Law by inducing MBIA to issue insurance policies guaranteeing payments under the CDS Contracts. As Merrill Lynch is aware, MBIA is subject to insurance regulations issued by the jurisdictions where it does business, including each of the fifty States, which prescribe, among other things, minimum capital requirements, minimum standards of solvency, and permitted classes and concentrations of investments, and require the filing of detailed annual financial statements. Merrill Lynch's fraudulent conduct exposes MBIA to financial risks and loss it would have never agreed to undertake in view of its regulatory mandates.

17. MBIA now brings this action to rescind the CDS Contracts and insurance policies with Merrill Lynch, and to recover all losses incurred under the CDS Contracts on the ML-series CDOs.

PARTIES

18. Plaintiff MBIA Insurance Corporation is a New York corporation with its principal place of business in Armonk, New York. MBIA is one of the nation's oldest and

largest monoline insurers, and provides financial guarantee insurance and other forms of credit protection predominately on financial obligations that are newly issued and sold or otherwise sold and transferred in secondary markets. Monoline insurers provide insurance on bonds against the risk of nonpayment of principal and/or interest by the issuer.

19. Plaintiff LaCrosse Financial Products, LLC is a Delaware corporation with its principal place of business in New York. LaCrosse was established in December 1999 to act as a counterparty for structured derivative products, primarily credit default swaps. Although MBIA does not have a direct ownership interest in LaCrosse, it is consolidated in MBIA's financial statements on the basis that MBIA, through financial guarantee policies, guarantees the obligations of LaCrosse under its credit default swaps.

20. Defendant Merrill Lynch, Pierce, Fenner and Smith Inc. ("MLPFS") is organized under the laws of Delaware with its principal place of business located in New York. MLPFS is a wholly-owned direct subsidiary of Merrill Lynch & Co.

21. Defendant Merrill Lynch International ("MLI") is organized under the laws of England and Wales with its principal place of business in London, England. MLI maintains offices at 4 World Financial Center, New York, NY 10080. For the transactions that give rise to the claims in this Complaint, Defendant MLI acted through its New York office. MLI is an indirect subsidiary of Merrill Lynch & Co.

JURISDICTION AND VENUE

22. This Court has jurisdiction under CPLR § 301 pursuant to section 13(b) of the ISDA Master Agreements which govern each of the respective CDS Contracts, and under which Defendant MLI submitted to the jurisdiction of this Court. By virtue of their locations and conduct within this State, this Court has jurisdiction over Defendants MLI and MLPFS pursuant

to CPLR §§ 301 and 302. Each of the Defendants has either expressly consented to the jurisdiction of this Court over contractual and all other claims arising out of the transactions at issue in this Complaint, or has a principal place of business in New York. Both Defendants have offices and regularly transact business within the State. Each participated in the transactions themselves and the negotiations and other activities within the State that led to the transactions giving rise to the claims in this Complaint.

23. Venue is proper under CPLR § 501 pursuant to section 13(b) of the ISDA Master Agreements which govern each of the CDS Contracts and under which Defendant MLI submitted to venue in this Court. Additionally, venue is proper under CPLR § 503 because Defendants have offices in this County and many of the wrongful acts alleged in this Complaint occurred in this County.

FACTUAL ALLEGATIONS

I. Merrill Lynch Fraudulently Induces MBIA To Enter the CDS Contracts

24. This case involves eleven credit default swaps under which MBIA wrote protection against the risk of nonpayment on the senior notes issued by four CDOs arranged and underwritten by Merrill Lynch during the period from September 2006 through March 2007. The ML-series CDOs at issue include, in chronological order: Broderick CDO 2, Ltd. ("Broderick 2"), Highridge ABS CDO I, Ltd. ("Highridge"), Broderick CDO 3, Ltd. ("Broderick 3"), and Newbury Street CDO, Ltd. ("Newbury Street").

25. A credit default swap is a contract where one party, the swap provider, agrees to assume the risk of loss for a "reference" asset in exchange for premium payments from the protection buyer. The risk assumed by the swap provider depends upon the characteristics of the reference asset. Where the reference asset is a CDO tranche, the swap provider's risk—and

hence the amount of premium charged under the CDS—turns directly on the quality of the CDO collateral and the structure of the CDO. Under the CDS at issue here, if the reference CDO tranches fail to pay principal and/or interest as scheduled, then MBIA must pay the amount of the shortfall to the protection buyer. If the arranging bank, here Merrill Lynch, misrepresents the credit characteristics of the collateral—inflating value and/or credit quality—the premiums charged will not adequately cover the risk of loss inherent in the credit default swaps.

26. MBIA is a financial guarantor. As of the time of the CDS Contracts, its products and services included providing coverage of the payment obligations of CDO securities by offering credit default swap protection through LaCrosse and related insurance policies that guaranteed the CDS payments through MBIA Insurance Corporation. MBIA's credit default swaps are structured as contracts between the protection buyer and LaCrosse through which LaCrosse agrees to assume the risk of default, or other defined credit events, of the CDO notes in exchange for premium payments. The swap contract includes the execution of a pre-printed ISDA Master Agreement between LaCrosse and the protection buyer, which governs the basic terms of the swap. Separately executed are a supplementary Schedule to the ISDA Master Agreement and a swap Confirmation, both of which set out the negotiated terms of the swap. The governing documents include the CDO offering documents, which set forth the characteristics of the CDO tranches that are covered by the CDS contract. MBIA also issues an insurance policy to the noteholder, guaranteeing LaCrosse's payments under the credit default swap contract. If the CDO fails to make a payment, LaCrosse's obligation to pay under the credit default swap passes to MBIA through the insurance policy.

27. Arranger banks, such as Merrill Lynch, market notes and credit default swaps in CDOs through documents that include: an Offering Circular that describes the

structural characteristics of the CDO, the credit quality of the collateral, and other matters; pitch books and other marketing materials; and an Indenture, which creates the CDO and defines the eligibility criteria for the collateral that the CDO may purchase. The arranger also procures and provides letters from the ratings agencies that assign credit ratings to each tranche of the CDO.

28. For actively managed cash-flow CDOs, such as the ML-series CDOs, the entity responsible for the management of the CDO collateral is known as the collateral manager. The ability of the collateral manager to change the portfolio is typically limited by the Offering Circular, the CDO Indenture, and the management agreement between the CDO and the collateral manager. The collateral manager is chosen by the arranger.

A. Merrill Lynch Accumulates Billions of Dollars in Mortgage Loans and RMBS on Its Balance Sheet and Develops Its "De-Risking" and "Mitigation" Strategies

29. Merrill Lynch's effort to market the CDS Contracts to MBIA was part of a larger scheme to offload billions of dollars in deteriorating U.S. subprime mortgages and other collateral that Merrill Lynch held on its books by packaging them into CDOs or hedging their exposure through swaps with insurers. Former Merrill Lynch & Co. Chairman and CEO Stanley O'Neal recently admitted that:

> As the market for [CDO] securities began to deteriorate in the first quarter [of 2007], [Merrill Lynch] began substantially reducing [its] warehouse risk by constructing CDOs.... During the [third quarter of 2007] and throughout the year, [Merrill Lynch] substantially reduced [its] net [CDO] exposures....

In fact, Mr. O'Neal understated the extent of Merrill Lynch's effort. The reality was that, saddled with impaired subprime-based debt securities and desperate to get these and other liabilities off its books, Merrill Lynch resorted to outright fraud.

30. According to an article published by the Wall Street Journal on October 25, 2007, Merrill Lynch transformed itself between 2002 and 2006 from a marginal player in the

mortgage loan securitization industry into, as it became known, the "Wal-Mart" of CDOs. Whereas in 2002, Merrill Lynch underwrote approximately $2.2 billion in CDOs, by 2005 Merrill Lynch underwrote a total of approximately $35 billion of CDOs, of which $14 billion were backed by securities tied to subprime mortgages. By 2006, Merrill Lynch had more than tripled its issuance of subprime CDOs, to over $44 billion and, through the first seven months of 2007, arranged more than $30 billion in mortgage CDOs. Merrill Lynch garnered enormous fees from its prodigious CDO underwriting practice, reaping more than $700 million in 2006 alone.

31. Merrill Lynch's break-neck CDO production accelerated even as overall demand for CDOs waned. By September 2006, in its single-minded pursuit of underwriting fees, Merrill Lynch carried on its books inventory amounting to $17 billion in subprime CDO holdings, $18 billion in mortgage-backed bonds ready to be parceled into CDOs, and another $14 billion in subprime loans waiting to be made into mortgage bonds, according to a February 2008 article by Bloomberg News.

32. To rid itself of this inventory and its exposure to price decline in mortgage loans, mortgage-backed debt securities, and other securities, Merrill Lynch embarked upon a strategy to flip the losing RMBS and CDO positions in its inventory into new CDOs. As a recently published article from the Associated Press has confirmed:

> [T]he bulk of the middle-rated pieces of CDOs underwritten by Merrill were purchased by other CDOs that the investment bank arranged.... Each CDO sold some of its riskier slices to the next CDO, which then sold its own slices to the next deal, and so on.

In essence, in order to avoid writing down on its books its declining CDO, RMBS, and other positions, and unable to find direct investors without realizing losses, Merrill Lynch engaged in a scheme to package and repackage its most toxic assets into CDOs, which would be sold to

unsuspecting investors or hedged through credit default swaps, while it continued to generate huge underwriting fees.

33. As part of these "de-risking" and loss "mitigation" strategies, Merrill Lynch designed complex CDO-squared and CDO-cubed structures and then arbitraged rating agency methodologies in order to obtain favorable but unwarranted credit ratings on its CDO tranches. Merrill Lynch, as arranger and underwriter for these CDOs, had detailed information about each of the RMBS and CDO securities that would be included in the closing-date pools of collateral for each new CDO. In particular, this information included loan-level detail on the tens of thousands of underlying loans and other collateral that made up the RMBS and CDOs that it sliced up and repackaged into new CDOs. Merrill Lynch knew and banked on the fact that, based on the published methodologies of S&P and Moody's, as well as its extensive collaboration with the rating agencies in its capacity as an arranger and broker-dealer, the rating agencies would not look through the RMBS and CDOs to the performance of the underlying loans in order to rate the new CDO transactions. In light of the actual data on performance, that meant, as Merrill Lynch intended, that the resulting credit ratings would not accurately reflect the true characteristics of the CDO securities but instead would overstate the credit quality.

34. Armed with these misleading ratings, Merrill Lynch engaged in an aggressive campaign to offload its exposure to mortgage-based and other debt securities by, among other things, securing credit default swaps from bond insurers.

B. Merrill Lynch Approaches MBIA To Provide Credit Protection for Four CDO Transactions Loaded with Its Bad Assets

35. Promoting itself as a leader in structured finance CDOs, Merrill Lynch approached MBIA between July 2006 and March 2007 and proposed that MBIA write protection on the senior tranches of a series of Merrill Lynch CDOs. Merrill Lynch represented that the

ML-series CDO tranches would be super-senior or senior interests rated AAA with substantial subordination protection, and that the ML-series CDO collateral would be composed almost exclusively of "high grade" quality assets (rated "A-" or above). Merrill Lynch was uniquely qualified to make these representations because it had structured the CDOs on which the CDS Contracts were based and it had sourced much of the collateral from its own inventory. As Merrill Lynch knew and intended to convey, an investment in legitimate AAA-quality super-senior/senior tranches backed by legitimate "high grade" quality collateral should carry, at inception, extremely low probabilities of loss. Consistent with the supposed very low expected losses on what were represented to be conservative investments, Merrill Lynch offered very low premiums to MBIA for the CDS Contracts, averaging less than 0.08 of one percent.

36. As part of its due diligence for each CDS Contract, MBIA had numerous discussions with Merrill Lynch from on or about July 2006 to March 2007 regarding the structure, nature, and terms of the CDOs, including the criteria by which assets would be selected for inclusion in the CDOs' collateral pools. Since 2004, MBIA's business strategy was to participate in only the most senior layers of CDO structures which should have featured low levels of ratings volatility, extremely low default propensity and, in the unlikely event of default, extremely low loss severity. MBIA generally ceased writing protection on riskier "mezzanine" CDOs (with collateral consisting primarily of BBB-rated securities). Accordingly, during its discussions with Merrill Lynch, MBIA expressed that it was interested in insuring only the conservative, risk-remote, senior and super-senior tranches of CDOs that were supported primarily by "high grade" collateral and above-average subordination protection.

37. Throughout these discussions, and knowing MBIA's strict insurance criteria, Merrill Lynch made repeated representations to MBIA as to:

(1) Collateral Quality: That the overall credit quality of the ML-series CDO collateral was primarily "high grade"—a level even higher than investment grade;

(2) Structural Subordination: That the reference CDO tranches had sizable subordination protection, including not just tranches exposed to the first loss but also subordinate tranches that were themselves senior AAA-rated securities;

(3) AAA-Quality of Wrapped Notes: That the reference CDO tranches were super-senior/senior and were of AAA quality;

(4) Historical Default Rates: That the past performance of securities comparable in credit quality to the reference CDO tranches exhibited extremely low default rates, with high recovery rates in the event of default.

Merrill Lynch made no disclosures to MBIA of its knowledge of the declining performance data of the underlying loans and asset classes—and therefore their true credit quality characteristics—and the inconsistency between such credit quality and the ratings on which it marketed the transactions.

38. Each of Merrill Lynch's representations in the categories above directly related to the likelihood that the ML-series CDOs would be able to fulfill their payment obligations to noteholders, and therefore whether MBIA would be likely to make payments under the CDS Contracts. Merrill Lynch's representations were material to MBIA's decision to assume the risk of nonpayment for each note.

39. Merrill Lynch's representations were contained in due diligence materials provided to MBIA before the deals closed. During MBIA's due diligence, Merrill Lynch provided to MBIA, among other things, Offering Circulars, Indentures, Pitchbooks, and rating agency letters that it had prepared and procured for the ML-series CDOs. For each ML-series CDO, Merrill Lynch also provided spreadsheets to MBIA (the "Portfolio spreadsheets") which detailed the par value and credit quality of each security in each CDO's collateral pool. These documents and the CDS Contracts purported to substantiate the representations made by Merrill

Lynch to MBIA. Among other things, the documents purported to confirm the subordination structure for which MBIA had bargained, the super-senior/senior AAA credit quality of the ML-series CDO tranches that MBIA was asked to wrap, and the generally "high grade" quality of the ML-series CDO collateral. The nature of the representations are the same across all the ML-series CDO transactions.

40. For example, to induce MBIA to enter into the CDS Contracts pertaining to the Broderick 3 transaction, Merrill Lynch delivered documents to MBIA making the following specific representations:

(a) On or about January 9, 2007, Merrill Lynch sent MBIA a Portfolio spreadsheet describing the collateral assets that would be included in Broderick 3. The data included a listing of each security that was to be included, the current face value of each security, and the credit rating issued to each security by S&P and Moody's.

(b) On or about January 21, 2007, Merrill Lynch sent MBIA a Pitchbook for Broderick 3. The Pitchbook stated that the notes to be wrapped by MBIA would be of AAA quality—and emphasized that the historical default rates for comparable assets were all below 0.3%, with many at 0% or near it. Additionally, the Pitchbook contained a "Representative Portfolio" for the CDO, indicating that it would be composed of collateral that was 95% "A" or above.

(c) On or about February 26, 2007, Merrill Lynch provided MBIA with the Final Offering Circular for Broderick 3. The Final Offering Circular stated that the

notes to be wrapped by MBIA would be AAA/Aaa, and that the insured notes would have at least 13.75% subordination.[1]

(d) On or about February 27, 2007, Merrill Lynch delivered to MBIA the Final Indenture for Broderick 3. The eligibility criteria in the Indenture stated that at least 95% of the collateral in the CDO would be "A" or higher. The Indenture stated that the notes to be wrapped by MBIA would be AAA/Aaa quality and that the insured notes would have at least 13.75% subordination. Additionally, the final version of the Indenture was accompanied by a schedule of the securities that would serve as collateral for Broderick 3 and listed the names, par value, and credit rating for each security.

(e) On or about February 27, 2007, Merrill Lynch provided MBIA with rating letters from S&P and Moody's stating that the wrapped notes were assigned a rating of AAA/Aaa, respectively.

(f) On or about February 27, 2007, Merrill Lynch provided MBIA with copies of the Confirmations of the terms and conditions of the CDS Contracts between LaCrosse and MLI in relation to Broderick 3. The Confirmations stated that the Class A-2 and A-3 notes to be wrapped by MBIA would be rated AAA/Aaa. The Confirmations, like each of the other Confirmations governing the CDS Contracts, also incorporated the Indenture by reference, including the terms of the subordination for the Class A-2 and A-3 notes.

41. Merrill Lynch made similar representations through a set of similar documents for each of the other three ML-series CDOs, which representations only varied with the particular terms of each deal. For each of those CDOs, however, Merrill Lynch represented

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[1] MBIA wrapped the super-senior tranches of the Broderick 2 and Highridge transactions, and the super-senior and senior tranches of the Broderick 3 and Newbury Street

that the MBIA-wrapped notes would be of AAA/Aaa quality with the substantial levels of subordination set forth in the table below:

DEAL	S&P RATING	MOODY'S RATING	SUBORDINATION	SOURCES
Broderick 2	AAA	Aaa	14%	Pitchbook, July 12, 2006 Offering Circular, August 31, 2006 Indenture, September 1, 2006 Rating Letters, September 1, 2006 Confirmation, September 29, 2006
Highridge	AAA	Aaa	13.5%	Pitchbook, November 13, 2006 Offering Circular, January 25, 2007 Indenture, January 25, 2007 Rating Letters, January 25, 2007 Confirmation, February 15, 2007
Broderick 3	AAA	Aaa	13.75%	Pitchbook, January 21, 2007 Offering Circular, February 26, 2007 Indenture, February 27, 2007 Rating Letters, February 27, 2007 Confirmations, February 27, 2007
Newbury Street	AAA	Aaa	10%	Pitchbook, February 5, 2007 Offering Circular, March 7, 2007 Indenture, March 8, 2007 Rating Letters, March 8, 2007 Confirmations, March 8, 2007

42. Furthermore, Merrill Lynch represented that the collateral underlying each of the wrapped CDOs would be of high grade quality, with the percentage of securities rated "A" and above ranging between 95% and 98% across all ML-series CDOs.

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transactions. The subordination levels discussed here refer to the purported subordination protection for the most junior tranche wrapped by MBIA in each CDO structure.

DEAL	PERCENTAGE OF ASSETS RATED "A" AND ABOVE NO LESS THAN	SOURCE
Broderick 2	95%	Pitchbook, July 12, 2006 Portfolio Spreadsheet, July 16, 2006 Indenture, September 1, 2006
Highridge	95%	Pitchbook, November 13, 2006 Portfolio Spreadsheet, December 11, 2006 Indenture, January 25, 2007
Broderick 3	95%	Portfolio Spreadsheet, January 9, 2007 Pitchbook, January 21, 2007 Indenture, February 27, 2007
Newbury Street	98%	Portfolio Spreadsheet, February 1,2007 Pitchbook, February 5, 2007 Indenture, March 8, 2007

43. In the Pitchbook for each ML-series CDO, Merrill Lynch also represented that the historical default rate for AAA/Aaa structured finance securities similar to the collateral and tranches wrapped by MBIA was 0% in most cases and less than 1% in all others. Merrill Lynch never disclosed that any of the collateral in the ML-series CDOs was worth far less than par at closing, or that these historical default rates were fundamentally misleading because the ML-series CDO collateral were not in fact comparable to the benchmarks set forth in the Pitchbooks.

II. MBIA, in Reliance on Merrill Lynch's Representations, Entered Into the CDS Contracts

44. Relying on Merrill Lynch's representations as to each transaction, MBIA entered into eleven CDS Contracts referencing senior tranches of the four ML-series CDOs,

including certain CDS Contracts with parties other than Merrill Lynch. The CDS Contracts were written to cover shortfalls in the payment of timely interest and ultimate principal, and wrapped tranches of the following four ML-series CDOs:

(a) *The Broderick 2 CDO*—MBIA entered into three credit default swaps referencing the super-senior tranches of Broderick 2: On September 29, 2006, MBIA entered into a $376,000,000 swap with MLI wrapping the A-1AD super-senior notes, and a $475,000,000 swap with Barclays Bank PLC ("Barclays") wrapping the A-1AT super-senior notes, which were ranked *pari passu* in the Broderick 2 structure. On October 20, 2006, MBIA entered into a $450,000,000 swap with Societe Generale wrapping the A-1AD super-senior notes. The wrapped notes represent $1.301 billion out of $1.6 billion in total notes issued by the CDO. The reference securities to the Broderick 2 CDS Contracts were purportedly protected by structural subordination of 14%.

(b) *The Highridge CDO*—MBIA entered into two credit default swaps referencing the super-senior tranches of Highridge: On January 25, 2007, MBIA entered into a $750,000,000 swap with Barclays wrapping the A-1AT super-senior notes. On February 15, 2007, MBIA entered into a $547,500,000 swap with MLI wrapping the A-1AD super-senior notes, which were ranked *pari passu* with the A-1AT notes in the Highridge structure. The wrapped notes represent $1.2975 billion out of $1.5 billion in total notes issued by the CDO, with purported structural subordination of 13.5%.

(c) *The Broderick 3 CDO*—On February 27, 2007, MBIA entered into three credit default swaps referencing the super-senior/senior tranches of Broderick 3: A $750,000,000 swap to HBOS wrapping the A-1 super-senior notes, a $225,000,000 swap with MLI wrapping the A-2 senior notes, and a $318,750,000 swap with MLI wrapping the A-3 senior

notes. The wrapped notes represent $1.29375 billion out of $1.5 billion in total notes issued by the CDO, with purported structural subordination of at least 13.75%.

(d) *The Newbury Street CDO*—MBIA entered into three credit default swaps referencing the super-senior/senior tranches of Newbury Street: On March 8, 2007, MBIA entered into a $450,000,000 swap with MLI wrapping the A-1 super-senior notes and a $800,000,000 swap with MLI wrapping the A-2 senior notes. On March 19, 2007, MBIA entered into a $550,000,000 swap with HBOS wrapping the A-1 super-senior notes. The wrapped notes represent $1.8 billion out of $2 billion in total notes issued by the CDO, with purported structural subordination of at least 10%.

45. On the basis of Merrill Lynch's representations, MBIA accepted annual premiums of between 7.75 and 8.25 basis points for each transaction—0.0775 to 0.0825% of the total amount of risk covered to enter the CDS Contracts, which wrapped $5.7 billion of notes in ML-series CDOs. The premiums payable to MBIA were extremely small relative to its total exposure, which reflected the fact that the swaps were supposedly written to cover exposure to the top, super-senior/senior tranches of "high grade" transactions.

III. Merrill Lynch's Access to Loan-Level Data Gave It Superior Knowledge and Expertise Concerning the True Credit Quality of the CDOs

46. The ML-series CDOs were highly complex structures that included hundreds of RMBS and CDO securities. Further, each RMBS was composed of thousands of mortgages, and each inner CDO was composed of hundreds of tranches of other RMBS and CDOs (each of which was composed of yet more mortgage loans and other securities). Both the ML-series CDO tranches and much of the underlying collateral were highly illiquid.

47. As the broker-dealer, warehouse provider, and arranger of the transactions, Merrill Lynch had access to loan-level and collateral performance data concerning the RMBS

and CDO securities owned by each ML-series CDO, and it actively monitored that information to assess the value and credit quality of the deals. Moreover, Merrill Lynch sourced much of the collateral for the ML-series CDOs off the inventory of unsold securities on its own balance sheet. By virtue of its loan-level-up analysis and its multiple positions as the arranger of the transactions and the originator of much of the collateral, Merrill Lynch was uniquely situated to evaluate the true value and credit quality of the CDO tranches wrapped by MBIA.

48. Each of the ML-series CDOs contained a substantial number of other Merrill Lynch-arranged CDOs and RMBS, giving Merrill Lynch specific knowledge regarding the collateral of these securitizations. For example, 17 of 23 securities in Broderick 2's inner CDO bucket (or approximately 67% of the total notional amount of the inner CDOs) were originated by Merrill Lynch. Thirteen of 29 of Highridge's inner CDOs (or 52% of notional value) were originated by Merrill Lynch, including the re-securitization of notes issued by Broderick 2. Similarly, 21 of 31 of Broderick 3's inner CDOs were originated by Merrill Lynch (or 65% of notional value) and Broderick 3 re-securitized notes issued by Highridge. At least 5 of 34 inner CDOs (or 13% of notional value) of Newbury Street were originated by Merrill Lynch. The Merrill Lynch-originated securities, most of which were sourced from the mezzanine tranches of the CDOs, were among the worst performing in the collateral pools.

49. Through its ownership of the First Franklin Financial Corporation ("First Franklin"), a subprime origination and servicing business which it acquired in December 2006, Merrill Lynch had an additional source of representative loan-level performance data relevant to the tens of thousands of mortgages that made up the collateral securities of the Highridge, Broderick 3, and Newbury Street CDOs prior to closing. This operation provided Merrill Lynch with access to real-time data about the declining subprime mortgage securities in the ML-series

CDOs in advance of later downgrades by rating agencies. As Merrill Lynch acknowledged in an earnings call on April 19, 2007, its purchase of First Franklin "enabled us to see trends emerge sooner and adjust underwriting standards and pricing more rapidly."

50. Merrill Lynch's knowledge of the actual problems in the ML-series CDOs' collateral at inception is further demonstrated by its rejection for internal use of the ratings and ratings-based modeling on which it marketed the transactions. Ratings are statements of present fact reflecting estimated default and recovery rates on debt securities. Merrill Lynch knew that the credit ratings it procured on its ML-series CDO tranches were, as it intended, materially misleading and inaccurate because the actual loan-level performance data demonstrated that likelihoods of default were far higher, and likelihoods of recovery far lower, than reflected in the ratings.

51. In recent earnings calls—long after the closing of the CDS Contracts—Merrill Lynch has disclosed that it disregarded internally both the ratings issued by the rating agencies and credit derivative indices (such as the ABX.HE, which tracks the value of mortgage-backed securities and CDOs) as not representative of the credit quality of the collateral in its CDOs. As Merrill Lynch knew based upon its data specific to the ML-series CDOs, the ratings issued by the rating agencies on its structured products did not accurately reflect the true credit quality of those products. The credit derivative indices were subject to distorting market forces that often failed to reflect, in real-time, fundamental deterioration in collateral value. As Merrill Lynch admitted in its October 24, 2007 earnings call, where market values were available, the "market has been ahead of where the rating agencies are, and we've looked to the market wherever possible as an indicator of value." And, in an earnings call on July 17, 2008, then-CEO John Thain effectively admitted that, based on Merrill Lynch's knowledge, even market

indices for the complex transactions in dispute do not accurately reflect the value of the collateral shown by the loan-level data: "[W]e do not use the ABX to hedge [CDO exposure]....[T]here would be huge, huge tracking error between the ABX and ... collateral value."

52. In effect, while marketing the CDOs based upon ratings as well as related indicia of credit quality, Merrill Lynch calculated its own profit and loss based on undisclosed data of the real-time performance of the tens of thousands of mortgages comprising the collateral. With this information at its disposal, and with its extensive experience issuing CDOs and RMBS, Merrill Lynch was aware, as of the closing of each CDS Contract, that the assets it was repackaging into the ML-series CDOs were not "high grade," were worth less than their par values, and were in fact deteriorating. Merrill Lynch, therefore, knew that the subordination structure of each CDO was compromised and that the AAA ratings of the super-senior/senior tranches were illusory, as both were dependent upon that collateral quality. Additionally, because the CDO collateral was impaired, Merrill Lynch knew its representations as to historical default rates of assets with similar credit ratings to the collateral and wrapped notes were false and misleading because the collateral and wrapped notes were not "similar" at all, but rather of a quality far inferior than their credit ratings reflected.

53. As Merrill Lynch knew and intended, the problems presented by its use of complex and opaque CDO-squared and CDO-cubed structures, the illiquidity of both tranches and collateral, its deliberate ratings arbitrage, systemic ratings lag, the "tracking errors" in the ABX and other indices, and its nondisclosures of data on the declining performance of the underlying loans in the ML-series CDOs as of the inception of the transactions, all made it virtually certain that reasonable and ordinary buy-side due diligence at the senior and super-senior level would not uncover its false representations as to the value and credit quality of the

ML-series tranches and collateral. Moreover, Merrill Lynch repackaged the mezzanine tranches of each ML-series CDO into other Merrill Lynch CDOs to ensure that investors with risk positions closer to first-loss would not conduct a loan-level analysis of the transactions.

IV. Merrill Lynch's Representations Were False

54. Merrill Lynch's closing and pre-closing representations as to the fundamental attributes of each ML-series CDO transaction were egregiously false—and known by Merrill Lynch to be false at the time they were made based on information available to Merrill Lynch as the broker-dealer, warehouse provider, and arranger of the transactions, and as owner of First Franklin. Specifically, Merrill Lynch misrepresented (1) the collateral quality of the securities underlying each ML-series CDO; (2) the amount of structural subordination protecting the wrapped notes; (3) the credit quality of the wrapped notes; and (4) that past performance of securities that were comparable in credit quality to the wrapped tranches and collateral exhibited extremely low default rates, in spite of Merrill Lynch's knowledge that these statistics were misleading because the benchmarked securities were not at all comparable.

55. Collateral Quality: Merrill Lynch's representations in the Pitchbook, Indenture, and Portfolio spreadsheets that the collateral underlying each ML-series CDO was almost exclusively "high grade" (with credit quality of "A-" or above) were false across the entire series of CDO transactions at issue. In fact, as Merrill Lynch's loan-level performance data revealed, the true credit quality of the ML-series CDO collateral was substantially below "high grade" and even below investment grade. Additionally, the collateral at closing was not at or near par. In fact, the securities serving as collateral for each ML-series CDO were priced egregiously off-market as of the closing of the ML-series CDO transactions.

56. For example, based on its loan-level performance data, Merrill Lynch knew as of the date the Broderick 3 CDS Contracts closed that the expected recovery value of the Broderick 3 collateral was only worth 76% of par. Additionally, Merrill Lynch had packed the collateral full of its own previously issued CDOs, and a full 21 of the 31 CDO securities in the inner CDO bucket (or 65% of the inner CDO bucket's notional value) were sourced from Merrill Lynch's inventory. Those securities included tranches from the following Merrill Lynch CDOs: Auriga CDO Ltd.; Costa Bella CDO Ltd.; Highridge ABS CDO I, Ltd.; IMAC CDO 2006-1 Ltd.; Istana High Grade ABS CDO I, Ltd.; Jupiter High Grade CDO IV, Ltd.; Kent Funding III, Ltd.; Kleros Preferred Funding III, Ltd.; Kleros Preferred Funding IV, Ltd.; Kleros Real Estate CDO IV, Ltd.; Libertas Preferred Funding IV Ltd.; Lexington Capital Funding III, Ltd.; Longridge ABS CDO I, Ltd.; Maxim High Grade CDO I, Ltd.; Mercury CDO III, Ltd.; Octans CDO I, Ltd.; Rockville CDO I, Ltd.; West Trade Funding CDO II, Ltd.; and West Trade Funding CDO III, Ltd. These securities (together comprising nearly 20% of the entire collateral pool) were among the worst performing of the collateral and as of the closing date were worth a shocking 40% off par—representing BB- credit quality or lower. (Merrill Lynch's re-securitization of prior CDOs even included unsold CDO tranches from its Highridge transaction.) Moreover, Merrill Lynch also included RMBS, including 8 RMBS off its balance sheet, that similarly were below "high grade." Because the overall expected recovery value of the Broderick 3 collateral was only 76% of par, it was more akin to a pool of junk bonds than the high grade collateral represented by Merrill Lynch.

57. Structural Subordination: As described above, Merrill Lynch represented that the tranches on which the CDS Contracts were written were either senior or super-senior, and offered a commensurate level of structural protection. These representations were of

particular importance because CDOs have hierarchically defined payment structures where junior tranches typically absorb all the losses—and indeed must experience total loss—before losses are felt in the senior tranches. Therefore, the amount of subordination protecting the wrapped notes (expressed as the percentage of the CDO value that is made up of notes junior to the wrapped notes) is a vital component in determining the risk characteristics and performance expectations of the notes. However, as to each ML-series CDO, the level of subordination represented by Merrill Lynch was in fact false because, as known to Merrill Lynch, the degradation of the underlying collateral had already wiped out most or all of the subordination protection as of the closing date of each CDS Contract.

58. For example, the Indenture, Pitchbook, and Offering Circular for Broderick 3 stated that the senior notes wrapped by MBIA would have subordination protection of approximately 13.75%. But as a direct result of the inclusion of inferior collateral, the supposed super-senior AAA-quality reference tranche of Broderick 3 was in fact no better than a BBB-quality tranche (with a value of approximately 15 points below the par amount reflected at closing) with little or no subordination protection, and the risk profile presented was fundamentally different than that which Merrill Lynch represented. On day one, Broderick 3 carried embedded losses of approximately $360 million, or 24% of the entire transaction. This amount far exceeded the 13.75% structural subordination that purportedly protected MBIA's conservative senior investment, entirely destroyed the subordination, and exposed it to an immediate risk of loss.

59. AAA-Quality of the Wrapped Notes: Merrill Lynch's representations that the wrapped notes had AAA ratings were also materially false and misleading. As Merrill Lynch

knew, the ML-series CDO tranches could not support AAA credit quality on the strength of the inferior collateral included as of day one.

60. For example, the Indenture, Confirmation, Pitchbook, and Offering Circular for Broderick 3 all misrepresented that the senior notes wrapped by MBIA had AAA quality. However, with losses at the time of closing amounting to nearly 24% of the CDO's value, and with the subordination utterly destroyed by this degradation, the ostensibly AAA-rated notes that MBIA purportedly wrapped had a true credit profile eight notches below that claimed by Merrill Lynch, or BBB.

61. Historical Default Rates: In the Pitchbook for each deal, Merrill Lynch marketed the CDOs on the basis of the credit quality of the wrapped notes and the underlying collateral and represented to MBIA that the default rate for securities comparable to the wrapped notes was close to zero. However, these representations were false and misleading because, as Merrill Lynch knew, these historical default rates did not apply to the wrapped notes or similar collateral securities because the degradation of the collateral had effectively lowered their credit quality to the point where they were no longer performing as high-grade securities.

V. MBIA Justifiably Relied on Merrill Lynch's Representations

62. MBIA's reliance on Merrill Lynch's false representations was in accordance with industry practice and was justified. In 2006-2007, the due diligence standard for a monoline insurer, which MBIA followed, was (1) due diligence on the expertise and integrity of the arranger and collateral manager, and (2) cash-flow ratings-based modeling and stress testing of the CDO tranches and collateral—with credit quality as indicated by rating the paramount input. It was not industry standard for a credit protection provider at a super-senior/senior level to perform a complete valuation of a complex CDO by assessing the

thousands of underlying securities and loans that made up the collateral of a CDO (including inner CDOs) in order to verify the representations of the arranger.

63. In fact, because the spreads (reflecting supposed risks) were so low, a loan-level-up analysis on CDO-squared and CDO-cubed structures would have far exceeded industry standards for monoline insurers on represented super-senior and senior tranches backed by "high grade" collateral. The economics of the transactions—based on the risks represented and the corresponding premiums paid by Merrill Lynch—did not reasonably permit MBIA to acquire and assess the performance data on the thousands of loans comprising each RMBS, and the loans and other collateral underlying the multiple additional RMBS, CDOs, and other debt securities in each inner CDO. It was customary and reasonable for monoline insurers and other investors at the super-senior and senior levels of high grade deals to rely upon the truthfulness of the representations of arranging banks as to the credit quality and subordination.

64. Merrill Lynch was well aware of MBIA's due diligence approach and deliberately marketed on the basis of representations as to CDO structure, ratings, and subordination, in order to take advantage of the limits of that approach. As MBIA expressed on an investor conference call dated August 2, 2007, its conservative investment philosophy depended upon transacting only at the most senior AAA levels of high grade transactions:

> [W]e made a pretty important business decision back in 2000, which related to attachment points and credit support required in these transactions. In 2000, we made the decision to only transact CDOs at a minimum AA level. In reality, the vast majority of deals we do in the current market are transacted at AAA or what we would call super AAA levels which are really multiples of the loss coverage required for AAA rating. This decision was really driven by a desire for ratings stability in this product. CDOs, by their very nature, lack a level of granularly [sic] that can be present in other structured credit products, because of that lack of granularity, rating stability or instability could be present in these deals, and that was obvious from early vintage CDOs. Moving up in the credit rating spectrum protected us, we feel, a little better from rating instability.

Thus MBIA specifically rejected multiple CDO transactions proposed by Merrill Lynch that did not meet its criteria of high grade credit quality. In its Form 10-K for the fiscal year ending December 28, 2007, MBIA again described its limited access to underlying loan data particularly as to the CDO-squared and CDO-cubed structures at issue:

> [T]he modeling of multi-sector CDOs requires analysis of both direct ABS as well as CDO collateral within the multi-sector CDOs, known as 'inner securitizations,' and we do not consistently have access to all the detailed information necessary to project every component of each inner securitization. Such 'inner securitizations' may themselves include CDO collateral. Therefore, in some cases we put greater reliance on the models and analysis of third party market participants and are not able to fully, independently and precisely verify each data point.

65. MBIA properly performed its due diligence, according to industry standards, based upon the information available to it, including Merrill Lynch's representations as to credit quality of the ML-series CDO tranches and collateral, subordination levels, and historical default rates of ostensibly comparable securities. This due diligence included, among other things: (1) a portfolio analysis that focused on the sector distribution and credit ratings of the collateral; (2) a cash flow analysis that took into account the default rate of the collateral based on their credit ratings as well as the subordination structure of the deal as a whole; and (3) a thorough review of the collateral manager for each transaction through interviews and background checks.

66. Merrill Lynch was aware of the customary due diligence practices of monoline insurers, and specifically aware that MBIA would not perform the reverse-engineering necessary to uncover its fraud. By virtue of the long-standing relationship between the two companies, which Merrill Lynch itself described as one based upon trust, and the extensive course of dealing across multiple prior transactions, Merrill Lynch knew that MBIA would rely upon its representations, that MBIA's due diligence was performed in accordance with industry

standards, and MBIA would not detect that Merrill Lynch was fraudulently misrepresenting the credit quality of the transactions.

VI. The True Facts Come to Light

67. Shortly after the CDS Contracts closed, and as Merrill Lynch knew it would, the collateral in the ML-series CDOs began to default at a rapid pace. Even the super-senior tranches protected by the CDS Contracts, ostensibly the most loss-insulated portions of each ML-series CDO, have suffered and will continue to suffer substantial losses in value. As a direct result of the problems in each ML-series CDO as of the closing date of each transaction, all of the AAA-rated senior tranches of the CDOs—portrayed by Merrill Lynch as AAA quality—have deteriorated in value and have been downgraded, as follows:

- Broderick 2 A-1AD and A-1AT Notes to CCC-/Ca;
- Highridge A-1AD and A-1AT Notes to CC/Ca;
- Broderick 3 A-1 Notes to CCC-/Ca, and A-2 and A-3 Notes to CC/C;
- Newbury Street A-1 notes to AA-/Caa3 and the A-2 notes to CC/C;

68. More broadly, as reported in a Reuters article dated July 31, 2008, all the CDOs arranged by Merrill Lynch in 2007 have performed poorly, and each "either had its best-rated portion cut to junk, is in technical default, is being liquidated, or is in danger of being liquidated." As derivatives analysts concluded, these outcomes demonstrate that Merrill Lynch knew or should have known that its selection of initial CDO collateral was highly adverse.

69. As a direct result of Merrill Lynch's fraud and other wrongful acts, the ML-series CDOs now cannot fulfill their payment obligations to noteholders and MBIA faces expected losses presently estimated in excess of several hundred million dollars.

CAUSES OF ACTION

FIRST CAUSE OF ACTION:
FRAUD BASED UPON AFFIRMATIVE MISREPRESENTATIONS
(Against Both Defendants)

70. MBIA repeats and realleges the allegations set forth above as though fully set forth herein.

71. This is a claim for fraud brought against Merrill Lynch relating to affirmative misrepresentations it made concerning all the CDS Contracts.

72. Merrill Lynch made material misrepresentations of fact and failed to disclose material facts necessary in order to make its statements not materially misleading in connection with MBIA's participation in each of the eleven CDS Contracts. In furtherance of its scheme to unload onto MBIA a portion of its subprime exposure which had materially deteriorated in value, unbeknownst to MBIA, Merrill Lynch misrepresented that, among other things: (a) the overall credit quality of the ML-series CDO collateral was primarily "high grade"—a level even higher than investment grade; (b) the reference CDO tranches had sizable subordination protection, including not just tranches exposed to the first loss but also lower tranches that were themselves senior AAA-rated securities; (c) the reference CDO tranches were super-senior/senior and had AAA credit quality; and (d) the past performance of securities comparable in credit quality to the reference CDO tranches exhibited extremely low default rates, with high recovery rates in the event of default.

73. Merrill Lynch knew that its statements were false and misleading or, at minimum, was reckless in not knowing whether the statements were true when the statements were made, and Merrill Lynch made the statements with the intent and expectation that MBIA would rely on them.

74. As a result of Merrill Lynch's misrepresentations described above, the CDS transactions wrapping the ML-series CDO notes were fundamentally different than what was presented to MBIA. Merrill Lynch's misrepresentations were material as to each deal as the characteristics of the CDOs described by Merrill Lynch directly reflected the ability of each CDO to make good on its payment obligations to noteholders and MBIA entered into and priced the CDS Contracts based on these misrepresentations.

75. MBIA reasonably relied on Merrill Lynch's misrepresentations and omissions regarding the CDS Contracts. Without these material misrepresentations and omissions, MBIA would not have entered into the CDS Contracts.

76. Merrill Lynch's conduct, as alleged herein, was willful, malicious, reckless, and without regard to MBIA's interests. Specifically, Merrill Lynch engaged in this deceptive conduct in order to avoid losses it knew it would suffer if the CDS Contracts did not close and to transfer those losses to MBIA.

77. As a direct, proximate, and foreseeable result of Merrill Lynch's conduct, MBIA has suffered harm. Accordingly, the CDS Contracts with MLI should be rescinded and the parties restored to the status quo, and MBIA should be awarded damages incurred under all the CDS Contracts in an amount to be determined at trial. As a result of Merrill Lynch's conduct, MBIA is also entitled to punitive damages.

SECOND CAUSE OF ACTION:
FRAUD BY OMISSION
(Against Both Defendants)

78. MBIA repeats and realleges the allegations set forth above as though fully set forth herein.

79. This is a claim for fraud brought against Merrill Lynch arising from its non-disclosure of material facts that it was under a duty to disclose relating to all the CDS Contracts.

80. In connection with marketing each of the CDS Contracts to MBIA, Merrill Lynch held itself out as having a superior market position and special expertise through its extensive experience in the industry as a broker-dealer, its purchase of the underlying collateral, its modeling capabilities, and its relationships with collateral managers. As a broker-dealer in the securities that comprised the collateral for the CDOs, Merrill Lynch possessed particular expertise with respect to the collateral, especially with respect to the illiquid and opaque inner CDOs. As arranger of the ML-series CDOs, Merrill Lynch was uniquely situated to explain the details, attributes, and conditions of the CDS Contracts and the underlying CDO collateral.

81. Based on its expertise, superior knowledge, and relationship with MBIA in connection with each of the CDS Contracts, and in light of its false, incomplete, and misleading representations, Merrill Lynch owed a duty to MBIA to disclose material facts about the ML-series CDOs on which the CDS Contracts were based. In particular, Merrill Lynch needed to disclose its unique knowledge of the collateral, valuation and modeling techniques, and facts about the ML-series CDO performance that made clear that the ratings did not fairly reflect the true risk inherent in the transactions.

82. Specifically, among other things, Merrill Lynch needed to disclose: (a) material facts concerning the credit quality of the collateral and the substantial deterioration of that collateral—including that the collateral was not in fact of "high grade" quality prior to the closing of the CDS Contracts; (b) that the deterioration in the collateral deprived the senior tranches wrapped by MBIA of their structural subordination that made them truly senior and

exposed MBIA to immediate loss; (c) that the ratings of the senior notes wrapped by MBIA did not accurately reflect their credit quality and in fact grossly underestimated the true risk of loss; (d) that the low default rates of securities comparable in credit quality to the reference CDO tranches and collateral did not accurately reflect the risk of default of the wrapped notes or collateral, which were more akin to junk bonds; and (e) that MBIA's risk of loss was not commensurate to the small premiums it was receiving. Such information was known to Merrill Lynch but not known or readily available to MBIA, and Merrill Lynch knew that MBIA was acting in reliance on the false, misleading, and inaccurate information provided by Merrill Lynch yet made no attempt to update or correct that information.

83. As a result of Merrill Lynch's fraudulent omissions described above, the CDS transactions wrapping the ML-series CDO notes were fundamentally different than what was presented to MBIA. Merrill Lynch's fraudulent omissions were material as to each deal as the characteristics of the CDOs that Merrill Lynch failed to disclose directly reflected the ability of each CDO to make good on its payment obligations to noteholders and MBIA entered into and priced the CDS Contracts based on incomplete knowledge.

84. MBIA reasonably relied on Merrill Lynch's misrepresentations and omissions regarding the CDS Contracts. Without these material misrepresentations and omissions, MBIA would not have entered into the CDS Contracts.

85. Merrill Lynch's conduct, as alleged herein, was willful, malicious, reckless, and without regard to MBIA's interests. Specifically, Merrill Lynch engaged in this deceptive conduct in order to avoid losses it knew it would suffer if the CDS Contracts did not close and to transfer those losses to MBIA.

86. As a direct, proximate, and foreseeable result of Merrill Lynch's conduct, MBIA has suffered harm. Accordingly, the CDS Contracts with MLI should be rescinded and the parties restored to the status quo, and MBIA should be awarded damages incurred under all the CDS Contracts in an amount to be determined at trial. As a result of Merrill Lynch's conduct, MBIA is also entitled to punitive damages.

THIRD CAUSE OF ACTION:
NEGLIGENT MISREPRESENTATION
(Against Both Defendants)

87. MBIA repeats and realleges the allegations set forth above as though fully set forth herein.

88. This is a claim for negligent misrepresentation brought against Merrill Lynch in connection with all the CDS Contracts.

89. Merrill Lynch made misrepresentations which it knew, or was negligent in not knowing, at the time to be false, in order to induce MBIA's participation in the CDS Contracts. Merrill Lynch falsely represented, among other things, that: (a) the overall credit quality of the ML-series CDO collateral was primarily "high grade"—a level even higher than investment grade; (b) the reference CDO tranches had sizable subordination protection, including not just tranches exposed to the first loss but also lower tranches that were themselves senior AAA-rated securities; (c) the reference CDO tranches were super-senior/senior and had AAA ratings; and (d) the past performance of securities comparable in credit quality to the reference CDO tranches exhibited extremely low default rates, with high recovery rates in the event of default. At the time it made these misrepresentations, Merrill Lynch knew, or at a minimum was negligent in not knowing, that these statements were false, misleading, and incorrect. Such information was known to Merrill Lynch but not known or readily known to MBIA or readily

available to MBIA and Merrill Lynch knew that MBIA was acting in reliance on mistaken information.

90. Merrill Lynch held itself out as having a superior market position and special expertise with respect to the proposed transaction through its extensive experience in the area. As the structurer and arranger of the ML-series CDOs, Merrill Lynch was uniquely situated to explain the details, attributes, and conditions of each of the CDS Contracts.

91. Merrill Lynch made these misrepresentations to induce MBIA to enter into the swaps. Based on its expertise, superior knowledge, and relationship with MBIA, in connection with each of the CDS contracts, Merrill Lynch owed a duty to MBIA to disclose material facts about the ML-series CDOs upon which the CDS Contracts were based.

92. MBIA reasonably relied on Merrill Lynch's misrepresentations which Merrill Lynch undertook no attempt to correct. Without these material misrepresentations, MBIA would not have entered into the CDS Contracts.

93. As a direct, proximate, and foreseeable result of Merrill Lynch's conduct, MBIA has suffered harm. Accordingly, the CDS Contracts with MLI should be rescinded and the parties restored to the status quo, and MBIA should be awarded damages incurred under all the CDS Contracts in an amount to be determined at trial. As a result of Defendants' conduct, MBIA is also entitled to punitive damages.

FOURTH CAUSE OF ACTION:
BREACH OF CONTRACT
(Against Defendant MLI)

94. MBIA repeats and realleges the allegations set forth above as though fully set forth herein.

95. This is a claim for breach of contract brought against Defendant MLI under each of the six CDS Contracts it entered into with MBIA. Each CDS Contract is governed by an ISDA Master Agreement, which is accompanied by a Confirmation as well as a supplementary Schedule.

96. Between September 2006 and March 2007, MBIA entered into six CDS Contracts with Defendant MLI to write credit default protection on securities with defined characteristics, including as to credit quality, protection through structural subordination, and collateral type, as set forth in the Final Offering Circular and Indentures for each of the ML-series CDOs and Merrill Lynch's related marketing material. The Confirmation for each of these CDS Contracts specifies the credit rating of the wrapped note (for example, the Broderick 3 CDS Contract for the A-2 tranche contains the clause, "Ratings: AAA (S&P)/Aaa (Moody's)") and also specifies the seniority level of the wrapped tranche in the reference CDO capital structure (the Broderick 3 CDS Contract for the A-2 tranche contains the clause, "Class: Class A-2 Second Priority Senior Secured Floating Rate Notes due 2050"). The Confirmations incorporate the Indentures by reference, which, in turn, incorporate and describe the Final Offering Circulars, and collectively specify the subordination protection for the tranches wrapped under each Confirmation. Thus, Defendant MLI agreed to deliver securities containing specified credit ratings and subordination characteristics.

97. Defendant MLI materially breached the CDS Contracts. In particular, Defendant MLI did not deliver: (1) securities with credit quality as represented by Defendant MLI and implied by the credit ratings on the face of the Confirmations; (2) legitimate super-senior/senior tranches in the ML-series CDOs protected by the subordination levels described in the Offering Circulars and Indentures, because there was little or no structural subordination as of the closing date; or (3) securities backed by legitimate "high grade" collateral. To the contrary, Defendant MLI, for its own profit and at the direct expense of MBIA, created and delivered to MBIA securities that were composed of deteriorated collateral that materially changed the risk profile of the tranches wrapped by MBIA by their closing dates. As a result, the credit quality of the MBIA-wrapped tranches did not warrant their AAA-ratings and did not have the levels of subordination represented by Defendant MLI. MBIA was thus exposed to risks associated with much lower-rated securities.

98. These material breaches of the CDS Contracts have exposed MBIA to risks that are materially greater than it had bargained for and are grossly out of proportion with what it is being paid. As a result, MBIA has been denied the benefit of its bargain, and there has been a material failure of consideration under the CDS Contracts.

99. MBIA has performed all of the material conditions, covenants, and promises required to be performed in accordance with the terms and conditions of the CDS Contracts. By contrast, Defendant MLI breached its material obligations to deliver CDO securities with the represented credit quality, subordination, and high grade collateral.

100. As a result of Defendant MLI's material breaches of the CDS Contracts, MBIA has suffered harm and should be awarded damages in an amount to be determined at trial. Defendant MLI's intentional and egregious misconduct also entitles MBIA to punitive damages.

FIFTH CAUSE OF ACTION:
BREACH OF COVENANT OF GOOD FAITH AND FAIR DEALING
(Against Defendant MLI)

101. MBIA repeats and realleges the allegations set forth above as though fully set forth herein.

102. This is a claim for breach of the implied covenant of good faith and fair dealing brought under each of the six CDS Contracts MBIA entered into with Defendant MLI.

103. Implied in each of the contracts governing the CDS Contracts is a covenant that the parties would deal with each other in good faith and would not engage in any conduct to deprive the other of the benefits of that agreement.

104. Defendant MLI deliberately and knowingly selected collateral for inclusion in each ML-series CDO that, as of day one of the transaction, had the effect of destroying the represented credit quality of the CDO tranches and the represented subordination protection of such tranches. Defendant MLI could have selected other securities that not only met the stated requirements for credit ratings but had the credit quality implied by such ratings.

105. As a direct and proximate result of Defendant MLI's knowing, intentional, and bad faith violations of the CDS Contracts' implied covenant of good faith and fair dealing, MBIA has suffered harm and should be awarded damages in an amount to be determined at trial. As a result of MLI's intentional and egregious misconduct, MBIA also is entitled to punitive damages.

SIXTH CAUSE OF ACTION:
RESCISSION OF INSURANCE POLICIES
(Against Defendant MLI)

106. MBIA repeats and realleges the allegations set forth above as though fully set forth herein.

107. This is a claim for rescission of the six insurance policies that MBIA Insurance Corporation issued to MLI guaranteeing LaCrosse's payment obligations under each of the CDS Contracts with Merrill Lynch.

108. Based on the material misrepresentations and omissions set forth above, MBIA Insurance Corporation is entitled to rescind the insurance policies under New York Insurance Law § 3105. Absent Defendant MLI's fraudulent conduct, MBIA would not have issued the Insurance Policies. MBIA relied on these misrepresentations and omissions in deciding to issue the Insurance Policies. Had MBIA known of Merrill Lynch's fraudulent misrepresentations and omissions, it would not have issued the insurance policies.

PRAYER FOR RELIEF

WHEREFORE, MBIA demands judgment against Defendants as follows:

(a) rescission of the CDS Contracts with MLI and related insurance policies;

(b) compensatory and punitive damages incurred under all the CDS Contracts and related insurance policies in amounts to be determined at trial, together with pre-judgment interest at the maximum rate allowable by law;

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

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

DATED: New York, New York
April 30, 2009

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