

PATTERSON BELKNAP WEBB & TYLER LLP
Philip R. Forlenza (*prforlenza@pbwt.com*)
Erik W. Haas (*ehaas@pbwt.com*)
Robert P. LoBue (*rplobue@pbwt.com*)
Peter W. Tomlinson (*pwtomlinson@pbwt.com*)
Ella Campi (*ecampi@pbwt.com*)
1133 Avenue of the Americas
New York, New York 10036
Telephone: (212) 336-2000
Fax: (212) 336-2222

*Attorneys for Ambac Assurance Corporation and
The Segregated Account of Ambac Assurance Corporation*

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

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AMBAC ASSURANCE CORPORATION and :
THE SEGREGATED ACCOUNT OF AMBAC : Index No. _____
ASSURANCE CORPORATION, :

Plaintiffs, :

- against - :

COMPLAINT

FIRST FRANKLIN FINANCIAL :
CORPORATION, BANK OF AMERICA, N.A., :
MERRILL LYNCH, PIERCE, FENNER & SMITH :
INC., MERRILL LYNCH MORTGAGE :
LENDING, INC., and MERRILL LYNCH :
MORTGAGE INVESTORS, INC. :

Defendants.

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Plaintiffs Ambac Assurance Corporation ("Ambac") and the Segregated Account
of Ambac Assurance Corporation (the "Segregated Account," collectively with Ambac,
"Plaintiffs"), by their attorneys, Patterson Belknap Webb & Tyler LLP, for their complaint
against defendants First Franklin Financial Corporation ("First Franklin"), Bank of America,

N.A. ("BANA"), Merrill Lynch, Pierce, Fenner & Smith, Inc. ("MLPF&S"), Merrill Lynch Mortgage Lending, Inc. ("Merrill Lynch Lending"), and Merrill Lynch Mortgage Investors, Inc. ("Merrill Lynch Investors," and collectively with First Franklin, BANA, MLPF&S, and Merrill Lynch Lending, "Defendants"), hereby allege upon personal knowledge as to themselves and as to their own conduct, and upon information and belief as to all other matters, as follows:

NATURE OF ACTION

1. Plaintiffs bring this action to seek redress for Defendants' material misrepresentations *and* pervasive breaches of the parties' agreements pertaining to a mortgage-backed securitization (the "Transaction") that Merrill Lynch Lending sponsored, that MLPF&S marketed, and that Ambac insured, and which consisted of loans originated by First Franklin and deposited by Merrill Lynch Investors into a trust, First Franklin Mortgage Loan Trust, Series 2007-FFC. The loans in the Transaction were serviced originally by Home Loan Services, Inc. ("HLS"), which was a subsidiary of Merrill Lynch & Co. Inc. at the time of the Transaction and which was merged with and into BAC Home Loans Servicing, LP, which, subsequently, merged with and into BANA.

2. Merrill Lynch Lending, Merrill Lynch Investors, MLPF&S, First Franklin and HLS, as affiliates under common control, acted in concert to induce Ambac to enter into an insurance agreement and to issue an insurance policy (the "Policy") covering payments due on certain of the securities issued in the Transaction, in case the underlying loans did not provide sufficient payments of principal and interest.

3. Merrill Lynch Lending, as sponsor for the Transaction, arranged for loans originated by First Franklin to be deposited with Merrill Lynch Investors, an entity whose only purpose was to aggregate loans for securitization. MLPF&S, as underwriter, marketed the

securities to investors. To enhance the marketability of the certificates, MLPF&S solicited, and Merrill Lynch Lending, First Franklin, HLS, and Merrill Lynch Investors contracted with, Ambac to issue the Policy.

4. To induce Ambac to issue the Policy, First Franklin and MLPF&S made numerous fraudulent misrepresentations directly to Ambac *in advance* of closing with respect to (a) the characteristics of the loans pooled for the Transaction, (b) the underwriting guidelines purportedly followed, and (c) the due diligence purportedly conducted to ensure the veracity of the represented characteristics.

5. Merrill Lynch Lending, Merrill Lynch Investors, HLS, and First Franklin (collectively, the "Merrill Lynch Contracting Parties") induced Ambac to participate in the Transaction by making numerous untrue representations and warranties in the "Operative Documents" (*see* n.17 *infra*) effectuating the Transaction (the "Operative Documents"). The Merrill Lynch Contracting Parties made two types of representations and warranties in the Operative Documents: *transaction*-level representations and warranties and *loan*-level representations and warranties.

6. The *transaction*-level representations and warranties guaranteed the accuracy of the information provided to Ambac concerning (a) First Franklin's mortgage lending and underwriting practices in general, (b) the characteristics of the pools of mortgage loans securitized in the Transaction, (c) the due diligence conducted on those mortgage loans, and (d) the financial condition of First Franklin, HLS, Merrill Lynch Lending, and Merrill Lynch Investors.

7. The *loan*-level representations and warranties guaranteed the accuracy of the information given to Ambac concerning the quality and attributes of each of the individual

mortgage loans that First Franklin originated for the Transaction. These representations and warranties included assurances that each of the loans in the Transaction had been properly underwritten, that the borrowers were not in breach of their obligations, and that the disclosures made pertaining to each individual loan were accurate, true, and complete.

8. Both the representations made by MLPF&S and First Franklin in advance of the closing *and* the loan-level and transaction-level representations and warranties made in the Operative Documents by the Merrill Lynch Contracting Parties were critical to Ambac's decision to issue the Policy.

9. Shortly after closing, the mortgage loans securitized in the Transaction (the "Mortgage Loans") began to default at an extraordinary rate. According to the most recent trustee reports, loans accounting for approximately 74% of the original principal balance of the trust have defaulted. The defaults deprived the trust of the cash flows required to pay down the respective securities and thereby required Ambac to make hundreds of millions of dollars in claim payments to investors to cover the defaults. .

10. In view of the widespread defaults, Ambac requested that the Merrill Lynch Contracting Parties provide it with loan files so that Ambac could review the files for compliance with the loan-level representations and warranties made by the Merrill Lynch Contracting Parties. The Merrill Lynch Contracting Parties dragged their feet and delayed in providing Ambac with the loan files that it was entitled to under the Operative Documents. Eventually, Ambac obtained the requested loan files, and Ambac, through its counsel, retained a consultant to conduct a loan-level review. That consultant has reviewed over 1,750 of the Mortgage Loans and has found breaches of representations and warranties in nearly 94% of those loans. Pursuant to the Operative Documents, Ambac demanded that First Franklin and Merrill

Lynch Lending cure the breaches or repurchase the breaching loans. In connection with its repurchase demands, Ambac provided the Merrill Lynch Contracting Parties with detailed descriptions of the pervasive breaches of the loan-level representations and warranties that its consultant had found.

11. In recognition of Ambac's obligation under its Policy to make payments attributable to shortfalls due to breaching loans, the parties' agreements require breaches to be addressed within specified time frames. Despite the contractually-mandated time frame and Ambac's detailed documentation of the loan-level breaches, the Merrill Lynch Contracting Parties required Ambac to enter into protracted negotiations that were not contemplated by the agreements. Although Ambac first made repurchase demands in December 2008, the Merrill Lynch Contracting Parties dragged their feet and only agreed to repurchase a handful of loans over the next 18 months. Finally, in August 2010, the Merrill Lynch Contracting Parties began buying back some of the loans that they were required to repurchase, but they still refused to buy back the majority of the loans that they are obligated to repurchase under the Operative Documents.

12. In sum, First Franklin and MLPF&S fraudulently induced Ambac to issue the Policy on a Transaction replete with loans that bear no resemblance to the pre-contractual representations First Franklin and MLPF&S made to Ambac or the contractual representations and warranties that the Merrill Lynch Contracting Parties made to Ambac. Defendants' actions have caused Plaintiffs to suffer enormous damages. Prior to its court-ordered rehabilitation, Ambac paid hundreds of millions of dollars in claims on the Policy, and after the initiation of the Ambac rehabilitation in Wisconsin state court, the Segregated Account has accrued – and continues to accrue – tens of millions of dollars of additional claims on the Policy.

13. Plaintiffs are entitled to redress for First Franklin and MLPF&S's massive fraud and the Merrill Lynch Contracting Parties' pervasive and material breaches, including damages sufficient to place Plaintiffs in the same position they would have been in had Ambac never insured the Transaction.

THE PARTIES

14. The actual and projected claims under the Policy contributed to the financial deterioration of Ambac, which is a Wisconsin-domiciled insurer. On March 24, 2010, the Wisconsin Office of the Commissioner of Insurance ("OCI") approved the creation of the Segregated Account of Ambac Assurance Corporation (the "Segregated Account") pursuant to Wisconsin Statute § 611.24. That same day, the Circuit Court for Dane County, Wisconsin, upon the Verified Petition of the Commissioner of Insurance (the "Commissioner"), placed the Segregated Account into statutory rehabilitation under Wisconsin Statutes §§ 645.31 and 645.32 on March 24, 2010. Pursuant to Wisconsin Statute § 611.24(3)(e), the Segregated Account is a separate Wisconsin insurer with the legal capacity and authority to sue in its own name and right. Ambac allocated the Policy and claims at issue in this action to the Segregated Account pursuant to the Plan of Operation for the Segregated Account attached to the Commissioner's Verified Petition (the "Plan of Operation").

15. The Commissioner is the court-appointed Rehabilitator of the Segregated Account. As Rehabilitator, the Commissioner has the authority to prosecute the claims in this action on behalf of the Segregated Account. Pursuant to Wisconsin Statute § 645.33(1), the Commissioner has appointed a full-time Special Deputy Commissioner to rehabilitate the Segregated Account.

16. Ambac is a Wisconsin corporation with its principal place of business in New York, New York. Under the Plan of Operation, Ambac performs specified management services for the Segregated Account and retains the right to receive any cash recoveries relating to the policies and claims that were allocated to the Segregated Account, including the Policy and claims at issue in this action.

17. First Franklin is a Delaware corporation with its principal place of business at 2150 North First Street, San Jose, California 95131.

18. BANA is a national banking association with substantial business operations and offices at the Bank of America Tower at One Bryant Park, New York, New York 10036. BANA's main office is located at 101 North Tryon Street, Charlotte, North Carolina 28246. On July, 1, 2011, BAC Home Loans Servicing, LP merged with and into BANA. Prior to this merger, on October 16, 2010, HLS had merged with and into BAC Home Loans Servicing, LP. Accordingly, BANA has now succeeded by law to all of HLS's liabilities, including its liabilities as a contracting party in the Transaction.

19. Merrill Lynch Lending is a Delaware corporation with its principal place of business at 250 Vesey Street, 4 World Financial Center, 10th Floor, New York, New York 10080.

20. Merrill Lynch Investors is a Delaware corporation with its principal place of business at 250 Vesey Street, 4 World Financial Center, 10th Floor, New York, New York 10080.

21. MLPF&S is incorporated in Delaware and its executive offices are located at 250 Vesey Street, 4 World Financial Center, 4th Floor New York, New York 10080. MLPF&S is wholly-owned by, and the principal operating subsidiary of, Merrill Lynch & Co.

MLPF&S is registered with the U.S. Securities and Exchange Commission as a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934. MLPF&S also conducts business under the name "Merrill Lynch & Co."

JURISDICTION AND VENUE

22. This Court has personal jurisdiction over First Franklin, BANA, Merrill Lynch Investors, Merrill Lynch Lending and MLPF&S pursuant to N.Y. C.P.L.R. §§ 301, 302, and 311. Each of the Defendants transacts business in New York. Further, in the Insurance and Indemnity Agreement between Ambac and the Merrill Lynch Contracting Parties, dated as of May 29, 2007 (the "I&I Agreement"), the Merrill Lynch Contracting Parties irrevocably submitted to the jurisdiction of any court in the State of New York located in the City and County of New York.

23. Venue is proper in New York County pursuant to N.Y. C.P.L.R. §§ 503(a) and 503(c) and because in the I&I Agreement, the Merrill Lynch Contracting Parties waived any defense based on venue.

BACKGROUND

A. Merrill Lynch¹ Aggressively Seeks Dominance in Mortgage Finance

24. The seeds of Merrill Lynch's effort to become a dominant force in the mortgage finance industry were planted in 2002, when E. Stanley O'Neal was named its Chief Executive Officer. O'Neal immediately sought to increase Merrill Lynch's participation in asset-

¹ The term "Merrill Lynch" refers to the conglomerate of companies under common control of Merrill Lynch & Co. Inc. At the time of the Transaction, MLPF&S and each of the Merrill Lynch Contracting Parties was a part of the Merrill Lynch conglomerate.

backed securities products, such as mortgage-backed securities ("MBSs"), and collateralized debt obligations ("CDOs"), which are securities backed by, among other things, pools of MBSs.

25. Driven by the goal of catching Bear Stearns and Lehman Brothers, its highly profitable competitors in this space, Merrill Lynch developed an insatiable appetite for mortgage loans, and especially for higher-yield subprime loans and other assets that constitute links in the mortgage-loan-securitization chain. Increasing its control over the origination of new mortgage loans was particularly critical to Merrill Lynch's goal of gaining dominance in mortgage finance, because by controlling the origination of more mortgage loans, Merrill Lynch increased its supply of mortgage loans that it could securitize.

26. Merrill Lynch had enormous financial incentives to securitize as many loans as possible in order to capitalize on the many revenue opportunities offered by the process of turning residential mortgages into securities, including: (i) loan-origination fees, (ii) servicing fees, (iii) gains on the sale of the mortgages to the securitization trusts, (iv) fees from underwriting MBSs, (v) gains and fees from sponsoring CDOs into which the MBS were repackaged, and (vi) gains and fees from trading in the MBSs and interests in the CDOs into which the MBSs were placed. Merrill Lynch sought to reap, and did reap, huge profits at each stage of this process of creating MBSs out of pools of mortgage loans, and then CDOs out of the MBSs. In order to increase these profits, Merrill Lynch dramatically escalated its mortgage-related securitization operations in 2005.

27. Between January 2005 and January 2007, Merrill Lynch acquired *twelve* major residential or commercial mortgage-related companies or assets, including loan-origination companies, to provide a steady stream of loans to be pooled, securitized, and sold to investors. During the same period, Merrill Lynch also acquired loan-servicing companies to

leverage these originations to earn servicing fees as well. As one Merrill Lynch insider told Fox News, "[u]nder E. Stanley O'Neal, Merrill Lynch 'went hog wild' . . . buying up right and left mortgage finance companies."²

28. Merrill Lynch used these acquisitions to vastly expand the volume of mortgage-backed securities it issued. By 2005, Merrill Lynch Investors had already securitized over \$57.9 billion in loans—and this nearly doubled to over \$97.4 billion in 2006. At its peak, in 2007, the volume of Merrill Lynch securitizations surpassed \$100 billion. By this time, Merrill Lynch had become the second-largest issuer of subprime mortgage-backed securities.

29. A major step in Merrill Lynch's rapid expansion occurred on December 30, 2006, when Merrill Lynch acquired First Franklin and HLS from National City Bank. At the time, First Franklin was the fifth-largest subprime loan originator. First Franklin's prodigious loan originations provided Merrill Lynch with a steady source of loans to turn into MBSs and CDOs. Dow Kim, then president of Merrill Lynch's Global Markets & Investment Banking Group, described the purchase of First Franklin as follows: "This transaction accelerates our vertical integration in mortgages, complementing the three other acquisitions we have made in this area and enhancing our ability to drive growth and returns."³ Michael Blum, then-managing director and head of Merrill Lynch's Global Structured Finance & Investments Group, said: "This acquisition, and the origination platforms in particular, fills an important gap for us domestically providing a significant presence in both the wholesale and online retail channels."⁴

² Elizabeth MacDonald, *Dumbest Bubble Deals*, Fox Bus., Jan. 27, 2009, <http://emac.blogs.foxbusiness.com/2009/01/27/deal-hangover>.

³ Press Release, Merrill Lynch, Merrill Lynch Announces Agreement to Acquire First Franklin from National City Corp. (Sept. 5, 2006), http://www.ml.com/index.asp?id=7695_7696_8149_63464_70786_70780.

⁴ *Id.*

Contrary to public appearances, however, the undisclosed truth was that First Franklin's lending practices had led it to hold portfolios of loans that were worth far less than their face value.

30. Unbeknownst to Ambac, in April 2007—just a few months after Merrill Lynch had acquired First Franklin from National City Bank and *before* Ambac issued its Policy on the Transaction—Merrill Lynch notified National City Bank that it was entitled to a nearly \$90 million dollar "price adjustment" on the acquisition. According to a complaint Merrill Lynch filed in 2008 against National City Bank, nearly half of the adjustment demanded in April 2007 was due to National City Bank's inappropriate valuation of the mortgage loans held by First Franklin.⁵ Even though Merrill Lynch demanded an adjustment to the purchase price based in large part on the inappropriate valuation of First Franklin mortgage loans in April 2007—*the same time that Ambac was in discussions to insure the Transaction*—no one from MLPF&S or any of the Merrill Lynch Contracting Parties ever disclosed this important fact to Ambac.

B. Merrill Lynch Falsely Touts the Integrity of First Franklin's Originations

31. In 2007 alone, Merrill Lynch issued more than \$22 billion in subprime residential MBSs. In order to generate investor demand for this huge volume of securities, Merrill Lynch convinced investors that the underlying mortgage loans were originated and underwritten pursuant to prudent practices and made to borrowers with the ability to repay them. One way Merrill Lynch accomplished this was by touting the lending practices of its new, flagship mortgage-lending subsidiary, First Franklin.

⁵ *Merrill Lynch Bank & Trust Co., FSB v. Nat'l City Bank*, No. 601062-08 (N.Y. Sup. Ct, filed April 10, 2008), paragraph 33.

32. On March 22, 2007, L. Andrew Pollock, the President and Chief Executive Officer of First Franklin, appeared before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate and testified about First Franklin's sound lending policies. Pollock noted that First Franklin had been in the mortgage business for 25 years and stated that it had "a proven history as a responsible lender, and a critical component to our success has been the disciplined underwriting we embrace as a company."⁶

33. Pollock further testified: "Specifically, we employ underwriting standards that assure the quality of the loans we originate. These underwriting standards are designed to ensure that borrowers can afford to repay the mortgages we originate, as well as those we have originated in recent years....We do not make loans based solely on collateral value; specifically, *all* loans are underwritten based on the applicants['] credit history and *ability to repay the debt.*"⁷

34. Pollock assured Congress that First Franklin maintained prudent lending policies. He testified: "We maintain strict broker approval and monitoring guidelines....We do not originate or purchase short term balloon loans....The shake-out in the mortgage market has taken place quickly for those originators that did not maintain a commitment to quality or a culture of discipline. First Franklin's 25 years of industry experience and our commitment to responsible lending standards has allowed us to weather the current difficult situation, and will enable us to continue to succeed in the future."⁸

⁶ *Statement at the Hearing on the Subprime Mortgage Market Before the Senate Committee on Banking, Housing and Urban Affairs*, 110th Cong. (Mar. 22, 2007) (statement of L. Andrew Pollock, President & CEO, First Franklin Financial Corporation) (hereinafter "Pollock Statement"), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=4ccca4e6-b9dc-40b1-bab5-137b3a77364d&Witness_ID=6f3e3338-8532-4558-acc2-c0d8e892bc3d.

⁷ *Id.* (emphasis added).

⁸ *Id.*

35. Despite its repeated pronouncements about its sound lending practices, First Franklin was a prolific originator of risky, higher-yielding loans that put volume ahead of all else, including in particular the quality of the loans that were being originated. With the collapse of the residential real-estate market, First Franklin's abysmal lending practices are now coming to light as borrowers who could never afford the loans they received from First Franklin default in droves. Statistics compiled by Standard & Poor's in 2010 place the performance of First Franklin-originated loans at or near the very bottom of the list of major issuers for the 2006 and 2007 loan vintages.⁹ Moreover, a recent complaint filed by American International Group, Inc. details the underwriting practices at First Franklin as told by former First Franklin underwriters, one of whom described the lending practices at First Franklin as "*basically criminal*."¹⁰

36. By October of 2007, Merrill Lynch could no longer hide that its subprime securitization machine was broken. On October 5, 2007, it announced that it had to write off \$100 million in relation to First Franklin.¹¹ Moreover, later that month, Merrill Lynch recorded the largest quarterly loss since its founding in 1914—an \$8.4 billion write-down for the year.¹² By March 5, 2008, less than one year after Ambac entered into the Transaction insuring

⁹ *U.S. Closed-End Second-Lien RMBS Performance Update: May 2010 Distribution Date*, Standard & Poor's Ratings Direct, June 24, 2010, at 6-8.

¹⁰ Complaint, *American International Group, Inc. et al. v. Bank of America Corporation et al.*, filed August 8, 2011, in New York State Supreme court, subsequently removed to the District Court for the Southern District of New York (Index No. 1:11-cv-06212).

¹¹ Bradley Keoun, *Merrill Lynch Reports Loss of \$8.4 Billion Writedown*, Bloomberg, Oct. 24, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=axuWCcMYMda0>.

¹² *Id.*

payments on securities backed by First Franklin loans, Merrill Lynch had decided to shut down First Franklin's operations completely.¹³

C. MLPF&S and First Franklin Fraudulently Induce Ambac to Issue its Policy

37. In February of 2007, MLPF&S solicited a bid from Ambac to insure a transaction containing First Franklin-originated loans that MLPF&S planned to securitize and market to investors. Ambac turned down this transaction, noting that it did not have sufficient familiarity with First Franklin, which Merrill Lynch had purchased just two months before. In the hopes of convincing Ambac to insure future First Franklin transactions, Ketan Parekh and Sonia Lee of MLPF&S arranged for Ambac employees to receive copies of First Franklin's Financial Investor Book (the "December Investor Book") and First Franklin's wholesale underwriting guidelines (the "Wholesale Guidelines").

38. The December Investor Book contained a discussion of Merrill Lynch's rationale for buying First Franklin and trumpeted the fact that First Franklin's "serious delinquencies are well below the industry and [its] individual competitors." It also represented that First Franklin maintained the highest level of underwriting and quality-control practices, including:

- 100% credit underwriting performed prior to funding;
- 100% loan-by-loan fraud-prevention due diligence;
- Pre-funding due diligence performed on every loan transaction;
- Verbal verification of employment on all borrowers regardless of document type of the loan program; and

¹³ Reuters, *Merrill Shuts Unit Making Home Loans*, N.Y. Times, Mar. 6, 2008, <http://www.nytimes.com/2008/03/06/business/06lend.html>.

- Credit alerts: all fraud alert options available through our credit vendors.

39. The Wholesale Guidelines similarly described First Franklin's purported diligent and disciplined lending operation, indicating, among other things, that "[i]t is First Franklin's objective to approve and successfully close quality loans to borrowers." The guidelines asserted that "[i]t is the duty of the underwriters to make reasonable and prudent decisions based upon the information contained in the loan file or requested by underwriting. The underwriter must confirm the validity of the information through careful review of all documentation in the loan file. Documentation includes, but is not limited to: employment, income, assets, credit reports, purchase contracts, appraisals, preliminary title reports, and other guideline requirements." And the guidelines detailed specific requirements for First Franklin's various loan programs. For example, the guidelines limited participation in the "Stated Plus Program" to "self-employed or salaried borrowers *purchasing or refinancing their primary residence*," and required that the "*underwriter must determine that the stated income is reasonable and realistic* when compared to the borrower's employment type, assets and credit history. . . . This product allows income to be stated, but *requires that the borrower provide verification of eligible liquid assets* equaling three months of the income stated on the [Form] 1003 as income verification." (Emphasis added.)

40. In April 2007, MLPF&S contacted Ambac to propose another transaction. On or about April 24, 2007, MLPF&S sent Ambac a preliminary loan tape and a Merrill Lynch analyst report on First Franklin. MLPF&S gave Ambac this information for Ambac to use in evaluating and modeling the risk of the proposed transaction. MLPF&S told Ambac that it had to make its decision on a bid by the following week.

41. MLPF&S and First Franklin provided Ambac with numerous updated versions of the Transaction loan tape (the "Mortgage Loan Tape") throughout the negotiation process. Typically, the Mortgage Loan Tape was provided as an Excel spreadsheet detailing certain key attributes for each of the more than 15,000 loans proposed for securitization, including the subject property's appraised value, the loan-to-value ratio, the borrower's debt-to-income ratio and FICO score (which attempts to gauge the borrower's creditworthiness), and the manner in which the property was to be occupied (*e.g.*, as a primary residence, as a second home, or as an investment property). In effect, the Mortgage Loan Tape purports to cull out and present the key attributes of the Mortgage Loans from the tens of thousands of pages of the underlying loan files that were created in connection with the origination of the Mortgage Loans (*e.g.*, loan applications, appraisals, credit reports, and income and asset verifications).

42. Ambac relied on the data in the Mortgage Loan Tape to model the risk associated with the Transaction and to decide whether to issue the Policy on the Transaction.

43. The Merrill Lynch analyst report that MLPF&S gave to Ambac in April 2007 was entitled "FFML Sub-Prime Monitor" and contained information about the comparative performance of outstanding First Franklin securitized pools. The Merrill Lynch report also celebrated the quality of First Franklin's underwriting, including (emphasis added):

First Franklin's stated objective is to approve and successfully close quality loans. . . .

To prevent loan fraud, every transaction is subject to pre-funding due diligence. . . . Verbal verification of employment is performed for all borrowers regardless of document type. . . . All red flags are researched and must be resolved prior to funding the loan.

44. Relying on the information provided to it and MLPF&S's representations about the quality of the underlying loan pool and First Franklin's underwriting procedures, on or about April 26, 2007, Ambac sent MLPF&S a preliminary bid letter. In the bid letter, Ambac

noted that it would perform on-site diligence of First Franklin's operations. Ambac also noted that it may require third-party due diligence, but might waive the requirement to the extent Merrill Lynch already performed a loan due diligence.¹⁴

45. Ambac scheduled a visit to First Franklin's offices in San Jose, California, for May 8, 2007. In preparation for the visit, Ambac sent Mr. Parekh of MLPF&S an agenda of topics to be covered as well as a request to "pull a sample of 30-40 files" to be reviewed. Mr. Parekh replied that there would be too many other investors visiting First Franklin that day to permit a review of the 30-40 loan files.

46. Mr. Parekh accompanied the Ambac representatives on the May 8, 2007 visit to First Franklin. Mr. Parekh arranged for Ambac to meet with Chief Credit Officer Alice Carmack, Director of Risk Management Rene Ramirez, Director of Regulatory Risk Mary McGuirk, and the Head of Capital Markets Steve Mageras, among others (the "First Franklin Executives"). During these meetings arranged by MLPF&S, the First Franklin Executives described First Franklin's management and organization, financial performance and liquidity, underwriting and origination practices, and quality-control processes.

47. Consistent with the information set forth in the December Investor Book that MLPF&S had provided to Ambac, the First Franklin Executives portrayed First Franklin as a disciplined mortgage lender that applied stringent underwriting standards to ensure the quality of the loans it originated. They represented that First Franklin had maintained stricter underwriting guidelines than its competitors in 2005 and 2006, and was tightening them to further enhance performance. The First Franklin Executives provided Ambac with

¹⁴ Bid Letter from Ambac to MLPF&S (Apr. 26, 2007).

documentation outlining the changes to their underwriting guidelines (the "Guideline Revisions").

48. The First Franklin Executives also gave Ambac documentation to corroborate their assertions regarding the performance of First Franklin's loans relative to that of its competitors' loans. The executives provided, for example, an analysis of first-payment defaults, which are defaults that occur when borrowers fail to make the first payment due on their loans (and which are often indicative of origination fraud). The First Franklin Executives touted First Franklin's historically low level of first-payment defaults relative to market-average first-payment default rates at the time. Moreover, the First Franklin Executives assured Ambac that First Franklin's branch and regional managers received variable compensation that was heavily tied to the performance of the loans and the percentage of first-payment defaults.

49. During the May 8, 2007 visit, First Franklin also gave Ambac a copy of an updated investor book, the First Franklin Financial Investor Book, dated May 2007 (the "May Investor Book"). The May Investor Book—bearing Merrill Lynch's iconic stylized bull logo, symbolizing a growing market—repeated the same assurances and representations that MLPF&S and First Franklin had provided both in the December Investor Book and orally regarding the strict underwriting analyses that it purportedly applied to each loan. In addition, the May Investor Book (a) reiterated First Franklin's assertions that it had lower first-payment defaults than the industry, (b) explained that first-payment defaults "represent 94.78% of 2007" year-to-date repurchases, suggesting that repurchase demands for reasons other than first-payment defaults (*i.e.*, for breach of representations and warranties) were minimal, and (c) set forth First Franklin's "action plan" to tighten its underwriting guidelines further.

50. Mr. Parekh was present for most, if not all, of the meetings during the May 8, 2007 visit. During this day of meetings, Mr. Parekh never corrected any of the statements made by the First Franklin Executives; nor did he or anyone from MLPF&S ever tell Ambac that any of the statements made by the First Franklin Executives during the visit were false or misleading. Moreover, Mr. Parekh did not tell Ambac during the due diligence visit that a month earlier Merrill Lynch had notified National City Bank that it was entitled to a nearly \$90 million dollar "price adjustment" on the acquisition of First Franklin due in part to National City Bank's inappropriate valuation of the mortgage loans held by First Franklin.

51. The May Investor Book that was provided to Ambac during the due-diligence visit arranged by MLPF&S assured Ambac that Merrill Lynch stood behind First Franklin and the quality of the loans in the Transaction. For example, the May Investor Book states: "Loan quality review and credit policy setting is performed by centralized groups who report into both the Merrill Lynch Chief Credit Officer and the First Franklin Chief Operating Officer, not First Franklin production."

52. Although First Franklin and MLPF&S denied Ambac's request to review loan files during the due diligence visit, Ambac tried again. On May 10, 2007, Ambac sent Mr. Parekh a list of loan file numbers culled from the Mortgage Loan Tape for which Ambac wanted a third-party due diligence firm to perform a file-level review. However, First Franklin imposed time limitations on the closing of the Transaction that the chosen third-party vendor could not accommodate.

53. In lieu of due diligence by a third-party, MLPF&S offered its own due diligence of the collateral. The practice of a monoline insurer relying on the due diligence performed by the underwriter or sponsor of a transaction was common in the industry in 2007.

Consistent with this industry practice, on or about May 14, 2007, Mr. Parekh sent Ambac the summary results of due diligence that MLPF&S had conducted on 1,968 of the loans proposed for securitization in the Transaction (the "Due Diligence Report"). The Due Diligence Report asserted that there was a low incidence of loans (approximately 7%) that did not conform with First Franklin's underwriting guidelines or had legal compliance or documentation problems. Mr. Parekh later walked Ambac through the Due Diligence Report in a follow-up telephone conversation. Ambac understood that, consistent with industry practice, the 7% of non-conforming loans identified in the Due Diligence Report were removed from the loan pool prior to the closing of the Transaction. In deciding to insure the transaction, Ambac relied on the Due Diligence Report provided by MLPF&S and its representations concerning that report.

54. Prior to the closing of the Transaction, MLPF&S also assured Ambac that Merrill Lynch would retain several of the subordinate tranches of notes in the 2007-FFC Transaction. This was important to Ambac as it reflected Merrill Lynch's assessment of the risk involved in the Transaction and was consistent with the numerous pre-closing representations that MLPF&S had made to Ambac about the Transaction.

55. Finally, MLPF&S marketed the securities issued in the Transaction pursuant to offering documents, including a Free Writing Prospectus, and a Prospectus, both dated May 15, 2007, and a Prospectus Supplement, dated May 25, 2007 (collectively, the "Offering Documents"), which were publicly filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933. As a matter of law, the Offering Documents were required to disclose all material facts concerning the securities offered, not contain any untrue statement of material fact concerning the securities, and not omit a material fact necessary to make the statements made therein, in light of the circumstances in which they were made, not

misleading. The Prospectus Supplement included the statement that: "All of the Mortgage Loans were originated generally in accordance with First Franklin Financial's Underwriting Guidelines."¹⁵ In advance of the closing of the Transaction, MLPF&S prepared and sent to Ambac drafts of the Offering Documents to induce its participation in the Transaction.

56. The disclosures in the Offering Documents of the risks associated with the securization were false and misleading in that they (i) mischaracterized the origination and underwriting practices, (ii) presented false data and metrics pertaining to the pool of loans to be securitized, and (iii) failed to disclose First Franklin's wholesale abandonment of its due diligence and quality control processes, which resulted in a securization replete with defective loans. Moreover, the representations in the Mortgage Loan Tape, the Due Diligence Report, the Wholesale Guidelines, the Guideline Revisions, and the May Investor Book and the December Investor Book, as well as the representations by the First Franklin Executives during the Due Diligence visit, presented First Franklin as a prudent loan originator and the Transaction as comprising loans that were generally compliant with specific underwriting guidelines and diligence practices and, thereby, had a certain risk profile.

57. Ambac's loan-level review (conducted at enormous effort and expense after the losses in the Transaction began to mount), which reflects a 94% breach rate, has confirmed that the representations MLPF&S and First Franklin made in advance of the closing of the Transaction were fraudulent.

58. First Franklin and MLPF&S knew or were reckless in not knowing that their pre-contractual representations were untrue or materially false and misleading because (i) First Franklin originated the loans, (ii) when Merrill Lynch bought First Franklin it performed

¹⁵ Prospectus Supplement, dated May 25, 2007, at S-30.

considerable due diligence and post-acquisition—*but prior to the Transaction*—demanded a "price adjustment" because First Franklin's loan portfolios did not have the value they were estimated to have and (iii) MLPF&S represented to Ambac that it had performed an extensive due diligence process on the loans in the Transaction, including comparing them to First Franklin's underwriting guidelines. Either MLPF&S did not conduct the diligence it represented, and, therefore, was reckless in making the representations it did with respect to the Transaction, or it did, and, therefore, knowingly made fraudulent representations with respect to the Transaction.

59. First Franklin and MLPF&S intended to induce Ambac's reliance on their materially false representations and actively concealed material information pertaining to the Transaction. First Franklin and MLPF&S's misrepresentations and omissions fraudulently induced Ambac to insure the securities issued in the Transaction. Ambac would not have issued its Policy or agreed to participate in the Transaction had it known the true facts.

60. Ambac reasonably relied to its detriment on First Franklin and MLPF&S's false and misleading pre-contractual representations and material omissions - contained in, among other things, the Mortgage Loan Tape, Offering Documents, the May Investor Book and December Investor Book, the Wholesale Guidelines and Guideline Revisions, and the Due Diligence Report. Further, as detailed below, Ambac negotiated for and received detailed loan-level representations and warranties from First Franklin and other affiliates of MLPF&S before it agreed to insure the Transaction.

61. Ambac's reliance on First Franklin and MLPF&S's representations was reasonable and consistent with the industry practice and the parties' bargain.

D. The Merrill Lynch Contracting Parties Make Representations and Warranties to Ambac

62. After MLPF&S solicited Ambac's participation in the Transaction, its affiliates—First Franklin, HLS, Merrill Lynch Investors, and Merrill Lynch Lending—provided contractual representations and warranties that Ambac required as a condition to issuing its insurance Policy. The shift was seamless both because MLPF&S made presentations alongside First Franklin in advance of closing and because Mr. Parekh, an MLPF&S investment banker, also explicitly acted on behalf of two of the Merrill Lynch Contracting Parties. Mr. Parekh is listed as the contact person for breach notifications for both Merrill Lynch Investors and Merrill Lynch Lending in the I&I Agreement pursuant to which Ambac agreed to issue the Policy.

63. The Transaction closed on May 29, 2007 and was effectuated through a series of agreements, executed by the Merrill Lynch Contracting Parties, that govern, among other things, the rights and obligations of the various parties with respect to the Mortgage Loans and the certificates that resulted from their securitization.

64. First, under two Mortgage Loan Purchase Agreements, dated May 1, 2007 ("the MLPAs"), First Franklin and Merrill Lynch Lending each sold several thousand second-lien, fixed-rate mortgage loans to their affiliate, Merrill Lynch Investors, the Depositor in the Transaction. Under the respective MLPAs, Merrill Lynch Lending and First Franklin each made numerous and detailed loan-level representations and warranties concerning, among other things, the origination (including, underwriting), servicing, and key attributes of the securitized loans.¹⁶

¹⁶ As detailed below, the representations and warranties made by Merrill Lynch Lending and First Franklin are essentially the same except that the MLPA executed by Merrill Lynch Lending makes clear that it is the Seller but not the Originator of the loans (First Franklin was the Originator).

65. Pursuant to a Pooling and Servicing Agreement also dated May 1, 2007 ("PSA"), Merrill Lynch Investors, as Depositor, sold and assigned its entire interest in the pooled loans and all of its rights under the MLPAs to the Series 2007-FFC Trust (the "Trust"). In total, approximately 15,812 subprime, second-lien, fixed-rate mortgage loans with an aggregate principal balance of approximately \$856 million were securitized in the Transaction. The Trust then issued various classes of certificates that would be paid from the cash flow of principal and interest payments for the pooled mortgage loans.

66. To enhance the marketability of the Class A Certificates, the most senior investment-grade class of certificates issued in the Transaction, the Merrill Lynch Contracting Parties entered into the I&I Agreement. In the I&I Agreement, to induce Ambac to issue the Policy, the Merrill Lynch Contracting Parties made numerous representations and warranties to Ambac concerning First Franklin's business and the securitized loans, including that First Franklin's and Merrill Lynch Lending's representations and warranties in the respective MLPAs were true and correct and were extended to Ambac. The Merrill Lynch Contracting Parties also agreed that Ambac was entitled to broad relief, including indemnification and reimbursement, in the event the representations and warranties proved to be inaccurate or untrue. The Merrill Lynch Contracting Parties are jointly and severally liable for any payments due to Ambac under the I&I Agreement.

67. Relying on the representations, warranties, covenants, and remedies contained in and encompassed by the I&I Agreement, the MLPAs, and the PSA, Ambac issued Certificate Guaranty Insurance Policy Number AB1082BE. Under the Policy, Ambac agreed to insure certain payments of interest and principal due on the Class A Certificates.

E. The Merrill Lynch Contracting Parties' Representations and Warranties Allocate Risk of Loss

68. The representations and warranties the Merrill Lynch Contracting Parties made to and for the benefit of Ambac allocated certain risks of loss in the Transaction. As the "Sponsor," "Seller," "Servicer," "Originator," and "Depositor" for the Transaction, the Merrill Lynch Contracting Parties assumed the risks associated with the origination, servicing, selection, and description of the loans included in the Transaction. That is, the Merrill Lynch Contracting Parties accepted the risk that their disclosures pertaining to the loans, and pertaining to their practices with respect to the loans, were untrue, inaccurate and incomplete (*i.e.*, false or misleading). Ambac, in turn, accepted the risk that mortgage loans *conforming to the Merrill Lynch Contracting Parties' representations and warranties* would not perform as expected.

69. This was a reasoned risk-allocation between sophisticated parties. Unlike Ambac, the Merrill Lynch Contracting Parties originated the Mortgage Loans and established the controls, protocols, and criteria governing the selection of loans in the Transaction. The risks associated with the origination, selection, and description of Mortgage Loans, therefore, was entirely within the Merrill Lynch Contracting Parties' control. As an insurer, Ambac was not involved in the process of vetting the borrowers to whom the Mortgage Loans were made, and therefore could only rely on the information given to it by the Merrill Lynch Contracting Parties. Accordingly, Ambac reasonably assumed only the market risk that the Mortgage Loans, *as represented and warranted by the Merrill Lynch Contracting Parties*, would not perform as expected.

70. The Merrill Lynch Contracting Parties made two types of representations and warranties to Ambac in the I&I Agreement to effectuate this reasoned risk allocation: transaction-level representations and warranties and loan-level representations and warranties.

Ambac would not have entered into the Transaction if it had known, as it now does, that the Merrill Lynch Contracting Parties had materially and pervasively breached either set of representations and warranties.

1. **Transaction-Level Representations and Warranties**

71. At the transaction level, the Merrill Lynch Contracting Parties made representations and warranties to Ambac as to the accuracy and completeness of all information furnished to Ambac about, among other things, the Merrill Lynch Contracting Parties' compliance with lending and securities laws, their financial condition, operations, mortgage-loan portfolios, underwriting, due-diligence and quality-control practices, and the aggregate characteristics of the loans included in the Transaction. These transaction-level representations and warranties are contained in the I&I Agreement, and include the following (emphasis added):

Section 2.01(g) *Financial Statements*. The Financial Statements of [Merrill Lynch & Co.] . . . (i) are . . . complete and correct in all material respects, (ii) present fairly the financial condition and results of operations of [Merrill Lynch & Co.] . . . and (iii) have been prepared in accordance with generally accepted accounting principles consistently applied Since the date of the most recent Financial Statements, there has been no Material Adverse Change in respect of the Sponsor, the Servicer, the Originator or the Depositor. . . . [N]one of the Sponsor, the Servicer, the Originator or the Depositor is subject to any contingent liabilities or commitments that . . . have a material possibility of causing a Material Adverse Change in respect of the Sponsor, the Servicer, the Originator or the Depositor.

Section 2.01(j) *Accuracy of Information*. ***Neither the Operative Documents***¹⁷ ***nor other information*** relating to the Mortgage Loans, the operations of the Sponsor, the Servicer, the Originator or the Depositor or the financial condition of the Sponsor, the Servicer, the Originator or the Depositor (collectively, the "Documents"), . . . furnished or to be ***furnished to the Insurer in***

¹⁷ "Operative Documents" means the I&I Agreement, the Class A-1 and Class A-2 Certificates, the PSA, and the MLPAs, as defined in the I&I Agreement.

writing or in electronic form by the Sponsor, the Servicer, the Originator or the Depositor in connection with the Transaction contains or will contain any statement of a material fact which was *untrue or misleading* in any material respect when made. . . . Since the furnishing of the Documents, there has been no change nor any development or event involving a prospective change known to the Sponsor, the Servicer, the Originator or the Depositor that would render any of the Documents untrue or misleading in any material respect.

Section 2.01(k) *Compliance with Securities Laws*. Each of the Sponsor and the Depositor represents and warrants as follows: (i) . . . the Offering Document does not contain any untrue statement of a material fact and does not omit to state a material fact necessary to make the statements made therein, in light of the circumstances under which they were made, not misleading

72. As demonstrated by the plain language of these representations and warranties, the Merrill Lynch Contracting Parties attested to, among other things, the truth, accuracy, and completeness of all the written and electronic documentation that they had provided to Ambac in connection with the Transaction. By way of example, the documentation encompassed by these representations includes (i) the Merrill Lynch Contracting Parties' financial statements, which contained assessments of the value of their mortgage-loan portfolio and any residual interests they maintained in the Transaction securities, (ii) the Offering Documents, (iii) the Mortgage Loan Tape, (iv) the December Investor Book and May Investor Book, (v) the Wholesale Guidelines, the Guideline Revisions, and all other underwriting guidelines and revisions thereto, (vi) the Due Diligence Report, (vii) the first-payment default analysis, and (viii) the FFML Sub-Prime Monitors.

73. These documents provided important information about the quality of First Franklin's underwriting and overall business. Together, they purported to paint a picture of First Franklin as a prudent, responsible, and financially-sound mortgage lender. By attesting to the truth, accuracy, and completeness of these documents, the transaction-level representations

and warranties acted as a guarantee that First Franklin acted prudently and responsibly in originating the loans in the Transaction. They were a guarantee that First Franklin underwrote loans that conformed with its oft-touted underwriting standards and that any non-conforming loans were the exception and not the rule. And they were a guarantee that First Franklin did not engage in wholesale, rampant misconduct or negligence resulting in a portfolio replete with defective loans.

2. The Loan-Level Representations and Warranties

74. In the I&I Agreement, the Merrill Lynch Contracting Parties also extended directly to Ambac the loan-level representations and warranties set forth in the MLPAs:

Section 2.01(1) *Operative Documents*. Each of the representations and warranties of the Sponsor, the Servicer, the Originator and the Depositor contained in the applicable Operative Documents and the Underwriting Agreement is true and correct in all material respects and each of the Sponsor, the Servicer, the Originator and the Depositor hereby makes each such representation and warranty to, and for the benefit of, the Insurer as if the same were set forth in full herein.

75. In the MLPAs, the Merrill Lynch Contracting Parties made numerous representations and warranties about the attributes of each Mortgage Loan in the Transaction, and thereby assumed the risk that those representations prove false. These representations and warranties include, among others, the following with respect to each Mortgage Loan included in the Transaction:¹⁸

§ 7.02(a)(1). The information set forth in the Final Mortgage Loan Schedule is complete, true and correct.

§ 7.02(a)(5). The Mortgage Note and the Mortgage are not subject to any valid right of rescission, set-off, counterclaim or defense, including the defense of usury, nor will the operation of any of the

¹⁸ The quoted representations and warranties are exactly the same in both of the MLPAs except as noted. The text provided is from the First Franklin MLPA.

terms of the Mortgage Note and the Mortgage, or the exercise of any right thereunder, render the Mortgage unenforceable (subject to bankruptcy, insolvency, moratorium, reorganization and similar laws or by equitable principles affecting the enforceability of the rights of creditors, including those respecting the availability of specific performance), in whole or in part, and to the Seller's knowledge no such right of rescission, set-off, counterclaim or defense has been asserted with respect thereto; . . .

§ 7.02(a)(7). Any and all requirements of any applicable federal, state or local law including, without limitation, laws governing prepayment penalties, usury, truth in lending, real estate settlement procedures, consumer credit protection, equal credit opportunity, fair housing and disclosure laws applicable to the origination (as such laws existed as of the date of origination) and servicing of mortgage loans of a type similar to the Mortgage Loans have been complied with and the consummation of the transactions contemplated hereby will not involve the violation of any such applicable laws.

§ 7.02(a)(14). There is no default, breach, violation or event of acceleration existing under the Mortgage or the Mortgage Note) [*sic*] and no event which, with the passage of time or with notice and the expiration of any grace period, would constitute a default, breach, violation or event of acceleration With respect to each Mortgage Loan, (i) the First Lien is in full force and effect, (ii) there is no default, breach, violation or event of acceleration existing under such First Lien mortgage or the related mortgage note, . . .

§ 7.02(a)(18). The origination practices used by the Seller with respect to each Mortgage Note and Mortgage have been in all respects legal, proper, prudent and customary in the mortgage origination and servicing industry for mortgage loans similar to the Mortgage Loans. The Mortgage Loan has been serviced in accordance with the terms of the Mortgage Note.¹⁹

§ 7.02(a)(21). The Mortgage Loan was underwritten in accordance with the Seller underwriting guidelines in effect at the time the Mortgage Loan was originated; and the Mortgage Note and

¹⁹ The provision in the Merrill Lynch Lending MLPA states: "To the best of the Seller's knowledge, the origination practices used by the Originator with respect to each Mortgage Note and Mortgage have been in all respects legal, proper, prudent and customary in the mortgage origination and servicing industry for mortgage loans similar to the Mortgage Loans. The Mortgage Loan has been serviced in accordance with the terms of the Mortgage Note."

Mortgage are on forms acceptable to Fannie Mae or Freddie Mac.²⁰

§ 7.02(a)(29). No selection procedures were used by the Seller to select those mortgage loans originally offered for sale by the Seller to the Purchaser (including the Mortgage Loans) that identified such mortgage loans as being less desirable or valuable than comparable mortgage loans otherwise being offered for sale by the Seller.

§ 7.02(a)(36). No predatory or deceptive lending practices, as defined by applicable federal, state or local law applicable to the Seller in effect on the origination date of the Mortgage Loan, including but not limited to, the extension of credit to the mortgagor without regard for the mortgagor's ability to repay the Mortgage Loan and the extension of credit to the mortgagor which has no apparent benefit to the mortgagor, were employed by the originator of the Mortgage Loan.

76. As the foregoing shows, among other things, the loan-level representations and warranties are breached to the extent a Mortgage Loan in the Transaction fails to conform with the applicable originating guidelines, § 7.02(a)(18), or does not bear the attributes disclosed on the Loan Schedule, § 7.02(a)(1), or to the extent any Mortgage Note is in default, §7.02(a)(14), including because of borrower misrepresentation in the application process.²¹ Thus, the loan-level representations and warranties are breached by, among other violations, Mortgage Loans made to borrowers (i) with unreasonable stated incomes or that otherwise have no reasonable ability to repay the loan, which would contravene any originating guideline, and/or

²⁰ The provision in the Merrill Lynch Lending MLPA states: "The Mortgage Loan was underwritten in accordance with the Originator's underwriting guidelines in effect at the time Mortgage Loan was originated; and the Mortgage Note and Mortgage are on forms acceptable to Fannie Mae or Freddie Mac."

²¹ First Franklin originated its loans using a standardized form of Mortgage Note. This form provides: "Borrower Loan Application. Borrower shall be in default if, during the Loan application process, Borrower or any persons or entities acting at the direction of Borrower or with Borrower's knowledge or consent give materially false, misleading, or inaccurate information or statements to Lender (or failed to provide Lender with material information) in connection with the Loan. Material representations include, but are not limited to, representations concerning Borrower's occupancy of the Property as Borrower's principal residence."

(ii) who falsely stated their income, which would render the information on the Loan Schedule untrue and the Mortgage Note in default. As discussed below, the Transaction pool is replete with such breaches and many others.

3. *The Repurchase Protocol*

77. In the event that any loan is in breach of the loan-level representations and warranties, Merrill Lynch Lending and First Franklin must cure the breach or repurchase the breaching loan (the "Repurchase Protocol").²² The Repurchase Protocol is set forth in the MLPAs and the PSA, and incorporated by reference for Ambac's benefit in the I&I Agreement.²³ The MLPAs provide that within sixty (60) days of the earlier of discovery by or notice to the "Seller"—*i.e.*, First Franklin or Merrill Lynch Lending—of any breach of a representation or warranty which "materially and adversely affects the value of a Mortgage Loan or the Mortgage Loans," the breaching party must cure the breach or repurchase the non-conforming loan.²⁴ This provision is mirrored in the PSA.²⁵

78. The I&I Agreement incorporates the Repurchase Protocol by reference.²⁶ It provides that breaching parties shall reimburse Ambac for any payment (plus interest) that Ambac makes under the Policy as a result of the breaching parties' failure to comply with its obligation to cure, repurchase, or provide a substitute for a breaching loan.²⁷ Under the I&I

²² The Repurchase Protocol provided a third option, namely the substitution for a defective loan of a "Qualified Substitute Mortgage Loan," provided, however, that such substitution could be effected within 120 days of the "Closing Date." MLPAs § 7.03.

²³ I&I Agreement § 2.01(l).

²⁴ MLPAs § 7.03.

²⁵ PSA § 2.03(c).

²⁶ I&I Agreement § 2.01(l).

²⁷ I&I Agreement § 3.03(b).

Agreement, Merrill Lynch Lending, Merrill Lynch Investors, HLS and First Franklin are jointly and severally liable.²⁸

79. The Repurchase Protocol was intended to address the inadvertent inclusion in the Transaction of the aberrant non-complying loan; it was not intended to be an alternative to the Merrill Lynch Contracting Parties' compliance with the extensive representations and warranties made to Ambac.

4. Contractual Remedies

80. The I&I Agreement affords Ambac broad contractual remedies beyond the Repurchase Protocol. The agreement explicitly states that, in the event of a breach, (i) Ambac may pursue any remedy "existing at law or in equity,"²⁹ and (ii) any and all remedies are cumulative and not exclusive.³⁰ Ambac is also entitled to indemnification for claims made as a result of the Merrill Lynch Contracting Parties' breaches of their representations and warranties,³¹ and may recover any expenses incurred in protecting, preserving, and enforcing its rights and remedies, plus interest.³²

F. Ambac Discovers Fraud and Pervasive Breach of the Parties' Agreements

81. First Franklin and MLP&S fraudulently induced Ambac to issue the Policy on a trust replete with defective loans. In addition, the Merrill Lynch Contracting Parties materially and pervasively breached the transaction-level and loan-level representations and warranties, as well as the I&I Agreement as a whole, by making materially false and misleading

²⁸ I&I Agreement §§ 3.04; 3.06.

²⁹ I&I Agreement §§ 5.01–5.02.

³⁰ *Id.*

³¹ I&I Agreement § 3.04(a).

³² *Id.* §§ 3.03(c), (d).

disclosures, and omitting material information, pertaining to their operations and the Mortgage Loans being sold to the Trust. Significantly, in direct contravention of its representations and warranties, the Mortgage Loans sold to the Trust were not originated or underwritten pursuant to First Franklin's own originating and underwriting practices, nor pursuant to prudent lending practices, and, instead, were made to borrowers with no ability to repay them.

82. As noted above, Ambac has undertaken a loan-level review of over 1,750 of the Mortgage Loans and has found breaches of representations and warranties in nearly 94% of those loans.

83. The breaching loans contain one or, in most cases, more than one defect, constituting breaches of the Merrill Lynch Contracting Parties' representations and warranties.

These defects include:

- Rampant fraud, primarily involving misrepresentation of the borrower's income, assets, employment, or intent to occupy the property as the borrower's residence (rather than as an investment), and subsequent failure to so occupy the property;
- Failure by the borrower to accurately disclose his or her liabilities, including multiple other mortgage loans taken out to purchase additional investment property;
- Inflated appraisals; and
- Pervasive violations of the loan originator's own underwriting guidelines and prudent mortgage-lending practices, including loans made to borrowers (i) who made unreasonable claims as to their income, (ii) with debt-to-income and loan-to-value ratios above the allowed maximums, or (iii) with relationships to the applicable originator or other non-arm's-length relationships.

84. The Merrill Lynch Contracting Parties' pervasive breaches materially and adversely affected Ambac's interests in the identified loans and the entire loan pool. Loans that are not appropriately originated and underwritten, or the key attributes of which are otherwise

misrepresented, are markedly more risky and therefore less valuable than loans not suffering from such defects.

85. The rampant and systemic fraud and total disregard of the represented underwriting guidelines identified in Ambac's review of the loans in the transaction further demonstrates that the pre-contractual representations made by MLP&S and First Franklin about First Franklin's lending practices and MLP&S's oversight and due diligence of those practices were fraudulent.

G. The Merrill Lynch Contracting Parties Frustrate the Repurchase Protocol

86. In May 2008, Ambac sought access to the loan files and applicable underwriting guidelines that it was entitled to under Section 2.02 of the I&I Agreement, so that it could assess the Merrill Lynch Contracting Parties' compliance with their representations and warranties. The Merrill Lynch Contracting Parties did not readily provide Ambac with the requested materials and instead stalled and delayed the process. Ambac eventually got the requested materials, and its counsel retained a consultant to review the loan files. The re-underwriting work done by Ambac's consultant demonstrated that the loans were replete with breaches of the Merrill Lynch Contracting Parties' representations and warranties. In December 2008, Ambac began providing the Merrill Lynch Contracting Parties with formal notices of breach in accordance with the terms of the Operative Documents, together with the detailed findings of its consultant that specifically identified breaches of loan-level representations and warranties. Ambac requested that the Merrill Lynch Contracting Parties comply with their obligations to repurchase or cure the non-conforming loans.

87. Although Ambac first made repurchase demands in December 2008, the Merrill Lynch Contracting Parties delayed the contractually required process and only agreed to

repurchase a handful of loans for the next 18 months. After thumbing their nose at the repurchase process for nearly two years, in August 2010, the Merrill Lynch Contracting Parties finally began buying back some of the loans that they were required to repurchase. However, they still refused, and continue to refuse, to buy back the vast majority of the loans that they are obligated to repurchase under the Operative Documents.

88. The Merrill Lynch Contracting Parties' deliberate frustration of the repurchase remedy further compounds the harm to Ambac. Instead of complying with Ambac's repurchase requests in a timely manner, the Merrill Lynch Contracting Parties have executed a delay-and-defer strategy. From the outset, the Merrill Lynch Contracting Parties have unilaterally imposed extra-contractual conditions on their repurchase of loans with evident breaches on a loan-by-loan basis. The Merrill Lynch Contracting Parties demanded that Ambac engage in protracted, multi-step reviews and negotiations of the detailed breaches. In the meantime, Ambac has paid extraordinary sums to cover amounts due to the insured investors as a result of the staggering numbers of defaulted loans.

H. Plaintiffs Are Entitled to Relief

89. Ambac would never have participated in the Transaction and issued its Policy had it known of First Franklin and MLPF&S's fraud *or* of the pervasive and material breaches of the Merrill Lynch Contracting Parties' representations and warranties. Defendants' pervasive misrepresentations and breaches pierce the very heart—and amount to a total repudiation—of the bargain struck by the parties. The loan portfolios that the Merrill Lynch Contracting Parties sold into the Transaction did not have the attributes or bear any resemblance to what was represented and warranted would be transferred. The Merrill Lynch Contracting

Parties' deliberate frustration of the loan-level contractual remedy further compounds the harm to Ambac.

90. In the meantime, Plaintiffs have incurred significant harm as a consequence of Defendants' malfeasance. Prior to its court-ordered rehabilitation, Ambac paid hundreds of millions of dollars in claims on the Policy, and after the initiation of the Ambac rehabilitation in Wisconsin state court, the Segregated Account has accrued tens of millions of dollars of additional claims on the Policy. Due to the high rate of delinquency and expected defaults, future borrower re-payment shortfalls affecting the Transaction are inevitable, and there will be substantial additional claims in the future.

91. Defendants' misconduct entitles Plaintiffs to be, among other things, (i) returned to the position they would have been in had Ambac not issued the Policy and (ii) compensated for the incremental harm incurred as a result of participating in the Transaction. At the very least, this relief requires the payment to Plaintiffs of all claims payments made and accrued to date and all future claims payments required to be made under the Policy.

FIRST CAUSE OF ACTION

(Fraudulent Inducement Against First Franklin and MLPF&S)

92. Plaintiffs reallege and incorporate by reference paragraphs 1 through 91 of this Complaint.

93. As set forth above, from February 2007 until the close of the Transaction, MLPF&S and First Franklin knowingly and with the intent to defraud, caused their employees and agents to make materially false and misleading statements and omitted material facts to induce Ambac to enter into the I&I Agreement and issue the Policy. Absent First Franklin and

MLPF&S's fraudulent inducement, Ambac never would have entered into the I&I Agreement or issued the Policy.

94. MLPF&S and First Franklin knowingly and with the intent to defraud, delivered to Ambac materially false and misleading documents, including the Mortgage Loan Tape, the Due Diligence Report, the May Investor Book and December Investor Book and the Offering Documents.

95. Ambac reasonably relied on First Franklin and MLPF&S's statements and omissions when it entered into the I&I Agreement and issued its Policy.

96. As a result of First Franklin and MLPF&S's statements and omissions, Ambac insured certain payments of principal and interest to holders of notes backed by a pool of loans that had a risk profile far higher than Ambac had been led to understand.

97. As a result of First Franklin and MLPF&S's false and misleading statements and omissions, Plaintiffs have suffered, and will continue to suffer, damages, including claims payments under the Policy.

98. Because First Franklin and MLPF&S committed these acts and omissions maliciously, wantonly, and oppressively, Plaintiffs are entitled to punitive damages.

SECOND CAUSE OF ACTION

(Breach of Representations and Warranties against the Merrill Lynch Contracting Parties)

99. Plaintiffs reallege and incorporate by reference paragraphs 1 through 98 of this Complaint.

100. The I&I Agreement is a valid and binding agreement between Ambac and Merrill Lynch Investors, Merrill Lynch Lending, First Franklin, and HLS (now BANA).

101. The MLPAs are valid and binding agreements with respect to which Ambac is an express third-party beneficiary.

102. Ambac has performed all of its obligations under the I&I Agreement.

103. The Merrill Lynch Contracting Parties have materially breached their representations and warranties under Section 7.02 and 7.03 of the MLPAs and Section 2.01 of the I&I Agreement.

104. Plaintiffs have been damaged and will continue to be damaged in an amount to be determined at trial.

THIRD CAUSE OF ACTION

(Breach of Repurchase Protocol against the Merrill Lynch Contracting Parties)

105. Plaintiffs reallege and incorporate by reference paragraphs 1 through 104 of this Complaint.

106. The Merrill Lynch Contracting Parties have materially breached their obligations under the Repurchase Protocol by refusing to repurchase, cure, or provide substitutes for the vast majority of the loans that have breached the Merrill Lynch Contracting Parties' representations and warranties for which notice has been provided by Ambac.

107. Plaintiffs have been damaged and will continue to be damaged in an amount to be determined at trial.

FOURTH CAUSE OF ACTION

(Material Breach of the I&I Agreement against the Merrill Lynch Contracting Parties)

108. Plaintiffs reallege and incorporate by reference paragraphs 1 through 107 of this Complaint.

109. The Merrill Lynch Contracting Parties induced Ambac to enter into the I&I Agreement and to issue the Policy by making extensive representations and warranties concerning the loans in the Transaction and by agreeing to broad remedies for breaches of those representations and warranties.

110. The Merrill Lynch Contracting Parties' representations and warranties were material to Ambac's decision to insure the Transaction, and Ambac was induced thereby to enter into the I&I Agreement and perform its obligations thereunder.

111. The Merrill Lynch Contracting Parties' pervasive and material breach of their representations and warranties, and their frustration of the loan-level repurchase remedy, constitutes a material breach of the I&I Agreement as a whole that has deprived Ambac of the very purpose of the parties' bargain.

112. Plaintiffs have been and will continue to be damaged and are entitled to damages to be determined at trial.

FIFTH CAUSE OF ACTION

(Indemnification against the Merrill Lynch Contracting Parties)

113. Plaintiffs reallege and incorporate by reference paragraphs 1 through 112 of this Complaint.

114. Pursuant to Section 3.04(a) of the I&I Agreement, Ambac is entitled to be indemnified by the Merrill Lynch Contracting Parties for all claims, losses, liabilities, damages, costs or expenses of any nature arising out of or relating to:

- (a) the negligence, bad faith, willful misconduct, misfeasance, malfeasance or theft committed by any director, officer, employee, or agent of the Merrill

Lynch Contracting Parties in connection with any transaction arising from or relating to the Operative Documents;

- (b) the breach of any of the Merrill Lynch Contracting Parties' representations, warranties, or covenants contained in any of the Operative Documents; and/or
- (c) any untrue statement of material fact contained in the Offering Document or the Registration Statement or any alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

115. The Merrill Lynch Contracting Parties have breached numerous representations, warranties, and covenants contained in the Operative Documents, committed negligence and/or malfeasance relating to the Operative Documents, and materially misstated or failed to disclose material facts in the Offering Documents, all of which has caused Plaintiffs to pay claims and incur losses, costs, and expenses, and Plaintiffs will continue to pay claims and incur losses, costs, and expenses as a result of the Merrill Lynch Contracting Parties' conduct.

116. Plaintiffs are entitled to indemnification for such amounts, to be determined at trial.

SIXTH CAUSE OF ACTION

(Reimbursement for Claims Paid and Attorneys' Fees and Costs Against the Merrill Lynch Contracting Parties)

117. Plaintiffs reallege and incorporate by reference paragraphs 1 through 116 of this Complaint.

118. Pursuant to Sections 3.03(b) and (d) of the I&I Agreement, the Merrill Lynch Contracting Parties agreed to reimburse Ambac for any payment, and interest on any payment, Ambac incurred as a result of their failure to substitute for or deposit an amount in respect of any defective Mortgage Loan, as required under the Operative Documents.

119. Pursuant to Sections 3.03(c) and (d) of the I&I Agreement, the Merrill Lynch Contracting Parties agreed to reimburse Ambac for any and all charges, fees, costs, and expenses paid or incurred, plus interest, in connection with, among other things, enforcing, defending, or preserving Ambac's rights under the Operative Documents.

120. Plaintiffs have incurred and will continue to incur in an amount to be determined at trial numerous expenses, including attorneys' fees and expert fees, to enforce, defend, and preserve Ambac's rights under the Operative Documents, and payments as a result of the Merrill Lynch Contracting Parties' failure to substitute for or deposit an amount in respect of any defective Mortgage Loan.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully pray for the following relief:

- A. For an award of all legal, equitable, and punitive damages, to be proven at trial, against First Franklin and MLPF&S for their fraudulent inducement of Ambac's participation in the Transaction and issuance of the Policy;
- B. For an award of legal, equitable, and any other damages to be proven at trial, for the Merrill Lynch Contracting Parties' pervasive and material breaches of their representations and warranties, and contractual repurchase, cure, or substitution obligations, constituting material breaches of the I&I Agreements and frustration of the parties' bargains;
- C. For an order compelling the Merrill Lynch Contracting Parties to comply with their obligations under the MLPAs § 7 and PSA § 2.03, to cure, repurchase, or substitute the loans that breach their representations and warranties;

- D. For an award of compensatory damages for the Merrill Lynch Contracting Parties' material breach of their representations and warranties under MLPAs § 7 and I&I Agreement § 2.01 in the Transaction, and their obligations to cure, repurchase, or substitute the loans that breach their representations and warranties pursuant to the remedial provisions of MLPAs § 7 and PSA § 2.03, in an amount to be proven at trial;
- E. For an order of indemnification for the claim payments and other losses and expenses Plaintiffs have paid or will pay in the future under the Policy pursuant to I&I Agreement § 3.04(a);
- F. For an order awarding reimbursement of Plaintiffs' attorneys' fees, and other costs and expenses incurred in enforcing, defending, or preserving their rights under the Operative Documents, pursuant to I&I Agreement §§ 3.03(b), (c), (d);
- G. For an order of prejudgment interest; and,
- H. For an order awarding Plaintiffs such other and further relief as the Court deems just and proper.

Dated: New York, New York
April 16, 2012

Respectfully submitted,

PATTERSON BELKNAP WEBB & TYLER LLP



Philip R. Forlenza (prforlenza@pbwt.com)
Erik Haas (ehaas@pbwt.com)
Robert P. LoBue (rplobue@pbwt.com)
Peter W. Tomlinson (pwtomlinson@pbwt.com)
Ella Campi (ecampi@pbwt.com)
1133 Avenue of the Americas
New York, NY 10036-6710
Telephone: (212) 336-2000
Fax: (212) 336-2222

*Attorneys for Ambac Assurance Corporation and
the Segregated Account of Ambac Assurance
Corporation*