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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. MBIA INC., Defendant.	07 Civ. ____ (______) **COMPLAINT**

Plaintiff Securities and Exchange Commission, for its complaint against defendant MBIA Inc., alleges as follows:

PRELIMINARY STATEMENT

1. This action arises out of a fraudulent transaction that MBIA executed to mask the true financial impact of a massive loss it suffered on its guarantee of municipal bonds. In 1998, MBIA learned that it would have to make good on its guarantee of $256 million of bonds issued by a set of hospitals owned by the Allegheny Health, Education and Research Foundation ("AHERF"), which had defaulted. The default would have resulted in the first quarterly loss in MBIA's corporate history. To counter the potential negative market reaction, senior MBIA executives

devised a scheme to obtain retroactive reinsurance that would cover the entire net present value of the anticipated loss, or about $170 million, for a nominal premium. The effect of the transaction was to offset the entire $170 million loss MBIA recorded on its income statement in the third quarter of 1998 with a roughly equivalent reinsurance recoverable, thus masking the AHERF loss and converting a quarterly loss into a gain. The transaction was a sham.

2. MBIA entered into three purported reinsurance contracts under which the reinsurers agreed to provide retroactive coverage of up to $170 million for the AHERF loss (the "excess of loss" or "reinsurance" contracts). The excess of loss contracts were written as if it was unclear whether the reinsurers would have to provide the full amount of the agreed upon coverage, and MBIA's files were likewise papered to make this appear to be the case. This purported uncertainty about the extent of the reinsurers' payout to MBIA was critical to the desired accounting. To the extent that the reinsurers' payments under the excess of loss contracts were not expected to vary significantly, such payments could not be treated as reinsurance for accounting purposes, and MBIA would not be able to mask the effect of the AHERF loss on its income statement by offsetting the reinsurance recoveries against the loss. In fact, MBIA expected that the reinsurers would be called upon to pay out under the excess of loss contracts.

3. Because the reinsurers expected to pay out under the reinsurance contracts, they protected themselves against loss on the transaction by entering into separate agreements by which MBIA agreed to cede to them future business (the "quota share contracts"). The quota share contracts, which covered a significant percentage of MBIA's portfolio, ceded to the reinsurers hundreds of millions of dollars in premiums on future business. Although the ceding contracts did not on their face constitute compensation to the reinsurers (because the reinsurers

were undertaking some limited risk associated with the ceded premiums), in substance, they were compensation, because the contracts ceded so little risk associated with the amount of premium received. Indeed, in the case of one reinsurer, which had agreed to pay $70 million of MBIA's AHERF loss, MBIA ceded $101 million in net premiums (representing $13 billion of underlying insurance risk), but then secretly agreed to re-assume all but $13 million of the risk in an oral side agreement, leaving the reinsurer with all the ceded premium and virtually no risk. With respect to the other two reinsurers, which each paid $50 million of the AHERF loss, MBIA ceded a tremendous volume of business based upon a formula that virtually assured that the reinsurers would be repaid in full for their payments under the excess of loss contracts, even taking into account the risk they would be undertaking on the ceded business.

4. In September 2004, the reinsurer with the oral side agreement sued MBIA to enforce the side agreement. The lawsuit led to an investigation by the Audit Committee of MBIA's Board of Directors, which concluded, in March 2005, that "it appears likely that such an [oral side] agreement" existed, and resulted in MBIA's restatement of its consolidated financial statements for the years 1998 through 2003. However, MBIA restated only the $70 million of reinsurance associated with the side agreement. It did not restate the remaining $100 million, which was improperly accounted for and which had been the subject of numerous misleading press releases and periodic filings.

5. As a result of the foregoing conduct, MBIA, directly and indirectly, has engaged, and may again engage, in violations of Sections 17(a) of the Securities Act of 1933 ("Securities Act"), and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, and 13b2-1 thereunder.

6. By this action, the Commission seeks: (a) disgorgement of all ill-gotten gains plus prejudgment interest; (c) civil penalties; and (d) such further relief as the Court may deem appropriate.

JURISDICTION

7. The Commission brings this action pursuant to the authority conferred upon it by Sections 20(b) and 20(d) of the Securities Act, 15 U.S.C. §§ 77t(b) and 77t(d), and Sections 21(d) and 21A of the Exchange Act, 15 U.S.C. § 78u(d) and 78u-1.

8. This Court has subject matter jurisdiction over this action pursuant to Sections 20(d) and 22(a) of the Securities Act, 15 U.S.C. §§ 77t(d) and 77v(a), and Sections 21(d)(2), 21(d)(3), 21(e), 21A and 27 of the Exchange Act, 15 U.S.C. §§ 78u(d)(2), 78u(d)(3), 78u(e), 78u-1 and 78aa.

9. MBIA, directly and indirectly, made use of the means or instruments of transportation or communication in, or the means or instrumentalities of, interstate commerce, or of the mails, in connection with the transactions, acts, practices, and courses of business alleged in this complaint.

RELEVANT ENTITIES

The Defendant

10. **MBIA Inc.** is a Connecticut corporation headquartered in Armonk, New York. Through its principal operating subsidiary, MBIA Insurance Corporation ("MBIA Corp."), the company is a leading financial guarantor and provider of specialized financial services. MBIA Corp. has a financial strength rating of Triple-A from Moody's Investors Service, Standard & Poor's Ratings Services, Fitch Ratings, and Rating and Investment Information, Inc. MBIA's

common stock trades on the New York Stock Exchange and it files periodic reports with the Commission pursuant to Section 13 of the Exchange Act.

Other Relevant Entities

11. **AHERF** is a nonprofit operator of hospitals in Pennsylvania. In 1996, MBIA guaranteed $256 million of bonds issued by a set of AHERF-owned hospitals known as the Delaware Valley Obligated Group ("AHERF bonds").

12. **Axa Re Finance** ("Axa") is an indirect subsidiary of Axa SA, an insurance group and asset management company headquartered in Paris, France. Axa SA's American Depository Receipts trade on the New York Stock Exchange under the symbol AXA. One of Axa SA's primary subsidiaries is Axa Re, which focuses on the property and catastrophe reinsurance business. Axa is a wholly-owned subsidiary of Axa Re that was formed in 1997 to expand Axa Re's presence in the financial guarantee markets.

13. **Muenchener Rueckversicherungs-Gesellschaft AG** ("Munich") is a German corporation whose core businesses are reinsurance, primary insurance and asset management.

14. **Zurich Reinsurance (North America), Inc.** ("Zurich"), was, at the relevant time, a subsidiary of Zurich Financial Services Group, a Switzerland-based insurance and financial services company. Zurich is now known as Converium Reinsurance (North America) Inc., and is part of Converium Holding AG, an independent international multi-line reinsurer with headquarters in Switzerland.

MBIA ENGAGED IN A FRAUDULENT SCHEME TO MASK THE EFFECT OF THE AHERF LOSS ON ITS EARNINGS

15. The AHERF loss was a significant event for MBIA. Not only was it the first sizeable loss in its history, but the loss exceeded MBIA's unallocated loss reserves by about

$100 million and was the subject of intense market concern. MBIA designed the AHERF reinsurance transaction specifically to address the anticipated market reaction by masking the effect of the loss on earnings. Ultimately, MBIA achieved the desired income statement effect by entering into an excess of loss contract and one or more quota share contracts with each of three reinsurers, the key monetary terms of which are summarized below.

Counterparty	Excess of Loss Coverage	Quota Share Contract Gross Premiums
Munich	$50 million	$98 million ($28 million to be paid in fourth quarter 1998)
Axa	$50 million	$97 million ($60 million to be paid by March 31,1999)
Zurich	$70 million	$145 million ($101.5 million net)
Total:	**$170 million coverage**	**$340 million gross ceded premium**

16. The quota share contracts were carefully devised to fully compensate the reinsurers for the amounts they expected to pay under the excess of loss contracts. In addition, they were structured and documented so as to pass scrutiny by MBIA's auditor. Specifically, certain aspects of the quota share contracts were changed or omitted and made the subject of separate, and in some instances secret, side deals.

BACKGROUND

MBIA's Business: Writing to a "Zero-Loss" Standard

17. MBIA, primarily through its subsidiary MBIA Corp., is and was at all relevant times, engaged in providing financial guarantee insurance for municipal and other government bonds and for structured finance obligations. Financial guarantee insurance provides an unconditional and irrevocable guarantee of payment, when due, of the principal and interest or other amounts owing on insured obligations. The value of MBIA's guarantee is dependent on its credit rating, which historically has been Triple-A. That Triple-A rating in turn is dependent on MBIA's financial condition and its ability to control its losses.

18. Because MBIA underwrites to a "zero loss" standard, the chance of a loss on account of a default on the issues it guarantees is, by design, typically small. According to MBIA, "[e]very transaction [the company] look[s] at is structured to a no-loss standard to avoid losses even under the worst probable case scenario." Therefore, although a loss, even a significant one, was possible, the company operated using a business model that assumed there would be no such losses, and at the relevant time, its history demonstrated that such losses were rare.

The AHERF Loss and Its Effect on MBIA's Stock Price

19. In 1996, the AHERF bonds were issued, with MBIA's guarantee. The AHERF bonds were not general obligation bonds backed by tax revenues. By the spring of 1998, it was apparent that AHERF was in financial distress and that MBIA would have to make good on its guarantee. As a result, the investment community was concerned about the possible negative impact on MBIA resulting from its AHERF exposure. This concern was exerting downward pressure on MBIA's stock price, which fell from a high of $77.94 in April 1998 to a low of $67.62 on June 15, 1998.

20. On July 21, 1998, AHERF filed for bankruptcy protection, and MBIA issued a press release stating that the AHERF bankruptcy would have no impact on its earnings because "the company's unallocated loss reserve [of approximately $75 million] will be sufficient to meet anticipated losses." The market remained concerned, and MBIA's stock price continued to fall. On September 2, 1998, AHERF announced that its 1997 financial statements would be restated and should not be relied upon. By September 10, 1998, the price of MBIA's stock had fallen to $46.30.

21. It was in this context that senior MBIA executives negotiated and executed the excess of loss and quota share contracts, for the purpose of masking the effects of the AHERF loss on MBIA's earnings and thus allaying the market's concern. The contracts were negotiated, structured, and documented by MBIA's then-chief executive officer and chairman of the board ("CEO") and its then-chief financial officer and later special assistant to the chairman ("CFO").

22. MBIA first announced a reinsurance solution during an investor call on September 11, 1998, and the news had an immediate positive impact on MBIA's stock price. By the close of business on September 11, the price had climbed to $52.09 from $46.30 the day before.

Ultimately, in a September 29, 1998 press release, MBIA announced that it had obtained $170 million in reinsurance for its anticipated AHERF loss and that as part of the reinsurance agreements it had "entered into strategic business relationships with highly rated reinsurers to provide them with future business." MBIA did not identify the reinsurers or provide details of the "strategic business relationships." After the issuance of this press release, and through the filing of MBIA's third quarter earnings release and Form 10-Q in mid-November, MBIA's stock price recovered so that by year end it was trading in the mid-60s.

23. The July press release and the September conference call and press release were deliberately or recklessly misleading. When the July release was issued, MBIA's own internal analysis was that the AHERF loss would likely exceed its unallocated loss reserves. When MBIA announced in the September conference call and the September press release that the loss would be covered by reinsurance, it knew that the excess of loss contracts were not agreements subject to reinsurance accounting but were in substance loans, and that the "strategic business relationships" were mechanisms designed to fully compensate the reinsurers for the amounts they had paid under the excess of loss contracts.

The Terms of the AHERF "Reinsurance" Arrangement and the Applicable Accounting Principles

24. The essence of the reinsurance arrangement was that Munich, Axa and Zurich each agreed to "reinsure" a portion of the AHERF loss retroactively, i.e., to pay MBIA for a loss that it had already incurred, in return for premiums on future MBIA business. The reinsurance arrangements took the form of excess of loss contracts, which were organized into three layers, with Munich bearing responsibility for the first $50 million of the AHERF loss, Axa responsible for a second $50 million layer, and Zurich responsible for a third $70 million layer. (In an excess

of loss reinsurance contract, a reinsurer pays its insured when the insured's loss is in "excess" of a set amount.) In return, MBIA agreed to pay the three insurers a nominal premium for the excess of loss contracts, and agreed to provide the reinsurers with, or "cede," future business, with total gross premiums of $340 million, under quota share contracts. (In a typical quota share contract, the reinsurer takes on a percentage of risk for a percentage of the premium, minus the expenses of the company providing, or "ceding," the risk and associated premiums.)

25. To achieve the desired accounting treatment, which would permit MBIA to offset the $170 million AHERF loss with the $170 million reinsurance gain in the third quarter, MBIA knew that the excess of loss contracts had to transfer insurance risk on the date they were agreed upon. The applicable GAAP is Statement of Financial Accounting Standards Number 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts ("FAS 113"). Paragraph 9 of FAS 113 sets out the requirements for transferring insurance risk:

> a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts[; and]
>
> b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.
>
> A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments is remote.

26. In addition, even if there had been sufficient variability as to the timing and amount of payments under the excess of loss contracts, to qualify for reinsurance accounting MBIA knew that it also had to be "reasonably possible that the reinsurer[s] [might] realize a significant loss on the transaction." To make that determination, the reinsurer's exposure and

compensation on all the applicable agreements had to be considered. FAS 113, according to FASB Staff Implementation Guide on FAS 113, requires that:

> [F]eatures of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured. (See EITF Topic No. D-34, question 13)

If, as was the case, it was not reasonably possible that the reinsurers would realize a significant loss on the arrangement, the payments under the excess of loss contracts could not be treated as reinsurance but rather would have to be accounted for as deposits.

27. In fact, the AHERF reinsurance arrangement failed the FAS 113 test because MBIA knew that its estimate of the loss was at least the amount of the reinsurance coverage, and each reinsurer expected to pay the full amount of its commitment. That fact alone meant that the arrangement could not be treated as reinsurance, even when combined with the quota share contracts. And because the quota share contracts were designed to compensate the reinsurers for their payments under the excess of loss contracts, it was not reasonably possible that the reinsurers would realize a significant loss on the excess of loss contracts.

MBIA's Misleading Announcements About the Impact of AHERF

28. On July 20, 1998, just one day before AHERF filed for bankruptcy protection, MBIA's surveillance department, which was responsible for preparing loss estimates for senior management, prepared a memorandum advising MBIA's president on reserving alternatives and press strategy regarding AHERF. The memo stated:

> We think $95-100MM – half way between the (highly unlikely) best case [of $57 million] and the much more likely worst stress case [of $136 million] is an appropriate starting point. We would expect that it is more likely than not we would have to ratchet the loss estimate up over the estimated two years it will take

for the bankruptcy case to play out. On the other hand, the presence of four current bidders may give us a better outcome than currently expected. Accordingly, choosing a half-way number seems like a reasonable course at this point.

29. The president and the CEO rejected the surveillance department's recommendation for a $95-$100 million reserve. They did so because the figure exceeded MBIA's unallocated loss reserves, a fact that they did not want to disclose to the market. If MBIA announced its actual estimate of the loss, it would have had to disclose in its Form 10-Q for the second quarter, which was being prepared at the time, that the company expected its loss on AHERF to exceed its unallocated loss reserve.

30. On July 21, MBIA issued a press release, approved by the president and the CEO, which stated that MBIA expected that its unallocated loss reserve (then approximately $75 million) would "be sufficient to meet anticipated losses from the bankruptcy filing," without any explanation of that conclusion. As a result, according to the release, "the company [did] not expect losses from this insured credit to affect its earnings."

31. The July 21 press release was false because it implied that MBIA's exposure on AHERF was less than $75 million, when in fact the company's own surveillance department was anticipating a loss perhaps as much as $136 million, and was recommending a reserve amount of $95-100 million, far in excess of $75 million.

32. On August 4, 1998, MBIA issued its second quarter earnings release. In the release, the CEO was quoted as saying that the company's unallocated loss reserves "will be adequate to handle the AHERF loss." This statement was restated essentially verbatim in MBIA's Form 10-Q for the quarter ended June 30, 1998, filed on August 14, 1998, in a note on subsequent events meriting mention. This statement was also incorporated in a prospectus MBIA

filed on September 28, 1998 in connection with a $150 million debenture offering, and in a later filing. The CEO had no reasonable basis to make such a statement because MBIA had no estimate of loss other than the surveillance department's suggested reserve of $95-100 million.

33. On September 1, the day before MBIA entered into the excess of loss contracts with Munich and Axa, MBIA senior executives received a briefing on the status of AHERF from the surveillance department. At that briefing, they were told that "[a]t expected Ch. 11 auction sales ranges of $500-650 [million], MBIA will suffer a [net present value] loss of $100-150 [million] on [its AHERF bond] exposure of $256 million net." Thus, by the eve of September 2, 1998, the earliest date by which MBIA claims to have reached agreements in principle to the purported reinsurance agreements with Munich and Axa, MBIA's loss estimates had climbed to approximately $100-150 million.

34. On September 11, 1998, MBIA held a conference call for the stated purpose of addressing "the sharp and precipitous decline in MBIA's stock price over the last two weeks." That call, which had over 250 participants from major investment banks and institutional investors, specifically addressed, among other things, the AHERF situation. On the call, the president and the CEO made several statements about reinsurance the company was in the process of arranging to cover its AHERF exposure, including the following:

- "we have been making arrangements, not yet finalized, in the reinsurance marketplace which at very little cost has the effect of more than doubling the general loss reserve."
- although the AHERF situation was "fluid," MBIA "continue[s] to believe that after the arrangements we are making as to reinsurance . . . , the unallocated reserve that we have at present will cover any losses that will be incurred by MBIA as a result of [AHERF.]"
- MBIA "did not believe there would be any earnings impact from [AHERF.]"

35. The statements in paragraph 34 were false because MBIA knew that the excess of loss contracts were not agreements subject to reinsurance accounting but were in substance loans.

36. The statements by MBIA's senior executives had the desired effect on the market. MBIA's stock price rose 12.4% over the previous day's close of $46.30 to $52.03, and remained in the $50s through the end of September.

THE NEGOTIATIONS WITH THE REINSURERS

37. The quota share contracts ultimately reached with the reinsurers took advantage of the unusually low-risk, high-return nature of the financial guarantee business. MBIA's business model, based on a "zero loss" underwriting standard, was exceedingly profitable. Historically, most of MBIA's insureds, such as municipalities, other government entities and private issuers of structured finance obligations, were able to make all principal and interest payments from reliable sources of revenue, such as general tax revenues and private consumer receipts. Moreover, unlike traditional insurance, the entire amount of the premium on most municipal and other government entity guarantee insurance is paid up front, when the policy is written. Thus, in ceding business to the reinsurers, MBIA was in reality ceding an expected profit stream on a low-risk business.

38. Moreover, to make certain that the reinsurers would be reimbursed through the quota share contracts, MBIA agreed to modify its usual ceding commission, which is the amount the ceding insurer (MBIA) typically charges a reinsurer for ceding business. The "ceding commission" is typically a fixed percentage of the gross premium ceded. MBIA's standard ceding commission was 32.5%; that is, MBIA usually retained 32.5% of the gross premiums it ceded to its reinsurers. But in the quota share contracts with Munich and Axa, MBIA used a sliding scale commission. For both Munich and Axa, MBIA agreed to lower its standard ceding commission from 32.5% to 17.5%, depending on the amount of losses the companies incurred on the risks they assumed. The sliding

scale commission was a mechanism to help protect the profit that the reinsurers expected from the quota share contracts.

39. MBIA's auditor reviewed the Munich and Axa quota share contracts to determine whether it was "reasonably possible that the reinsurer [might] realize a significant loss from the transaction," when the excess of loss contract was combined with the quota share contract. The auditor advised MBIA senior executives that its quota share contracts with Munich and Axa as initially proposed did not pass the FAS 113 test. As a result, the agreements were changed and certain aspects were made the subject of separate agreements.

The Negotiations with Munich

40. The negotiations with Munich began in late July, 1998. From the beginning, Munich assumed that it would be paying the full $50 million on the excess of loss contract. As a result, the negotiations focused on the quota share contracts and making certain that Munich would be fully reimbursed. Under the initial quota share proposal, MBIA was to cede $98 million in premiums to Munich with a sliding scale commission. MBIA also agreed that the premiums would be ceded on a facultative basis – that is that Munich could choose from among the business MBIA sought to cede to it, unlike a typical quota share contract in which the contract identifies the types of risk the reinsurer has agreed to accept and the insurer has agreed to cede, but does not allow the reinsurer to reject any risk of the type agreed upon. By having the right to select only the risks it wanted, Munich minimized its risk even further.

41. MBIA's auditor rejected the initial proposal because "the way it is currently structured there is no reasonable chance that [Munich] would lose money." The auditor indicated that in order to pass the risk transfer requirements, the premium ceded under the quota share contract with a sliding scale could not be more than $70 million.

42. Because they knew that $70 million would not be sufficient compensation for Munich, the MBIA senior executives proposed that MBIA and Munich enter into two agreements, the first for $70 million, which the auditor had indicated would pass the FAS 113 test, and a second that ceded $28 million in additional premiums. This second quota share agreement did not have a sliding scale, but provided that all premiums would be paid before the end of 1998. With that feature, the two contracts effectively achieved the objective of providing adequate compensation to Munich. And under the analysis MBIA's auditor employed, there was virtually no chance that Munich would lose money on the deal.

The Negotiations with Axa

43. MBIA also began to negotiate the quota share contract with Axa in July. By the end of August, Axa expected that it would have to pay at least $30 million of its excess of loss contract. Axa also knew, however, that there was a substantial chance that it may need to pay the full $50 million due under the excess of loss contract.

44. To ensure that Axa would be fully compensated in either event, MBIA and Axa agreed that MBIA would cede $60 million in premiums with a sliding scale commission under the excess of loss contract. Of this $60 million, $23 million was to be ceded by March 30, 1999. In addition, senior MBIA and Axa executives proposed what they referred to as a "gentlemen's agreement," which initially had a "springing quota share" feature, as well as a sliding scale commission. Under the "gentlemen's agreement," MBIA agreed to cede an additional $37 million in premiums if Axa had to pay more than $30 million on the excess of loss contract.

45. The MBIA and Axa senior executives had planned not to memorialize this "gentlemen's agreement." However, MBIA's auditor learned about the "gentlemen's agreement," and initially said that the arrangement could be part of the written contract. But after reviewing a

draft of the quota share agreement with the "springing" provision included, it said that such a provision could not be part of the written contract.

46. Axa and MBIA therefore entered into a quota share contract for $60 million. On that basis, MBIA's auditor approved reinsurance accounting for the reinsurance arrangement with Axa.

47. MBIA and Axa also entered into the "gentlemen's agreement" that the auditor had rejected. This oral side agreement provided Axa with an additional $37 million in premiums, also with a sliding scale commission. By the time the agreement was memorialized in December 1998, the "springing" feature was dropped, because it was known that Axa would have to pay the full $50 million under the excess of loss contract. It was also agreed that the entire $37 million was to be ceded by the end of the month. Consequently, of the $97 million in total premiums ceded to Axa, $60 million was to be ceded by March 30, 1999.

<u>The Announcement of the Reinsurance Solution and Its Impact on Earnings</u>

48. On September 29, 1998, the bankruptcy court conducted an auction of AHERF's assets. The auction resulted in gross proceeds of $345 million. From this amount, MBIA later claimed that it was able to estimate a $170 million net loss on AHERF. Also on September 29, MBIA issued a press release entitled "MBIA Announces Exposure to Bankrupt Pennsylvania Hospital Group to be Covered by Reinsurance Agreements; Expects no Impact on Earnings." In the press release, MBIA announced that it had "obtained $170 million of reinsurance that it expects will cover anticipated losses arising from [AHERF]."

49. The September 29 release was false. On September 2, the earliest date by which MBIA claims to have reached agreements in principle with Munich and Axa for excess of loss coverage on the first $100 million of its AHERF exposure, MBIA and the reinsurers knew that the best estimate of MBIA's loss was at least $95 to $100 million. Because there was no uncertainty as

to the amount the reinsurers would pay, the excess of loss contracts did not transfer any risk under FAS 113. Moreover, the reinsurers expected to be fully compensated for their payouts, which also precluded reinsurance accounting under FAS 113.

THE TROUBLE WITH ZURICH AND THE SECRET SIDE AGREEMENT

50. After MBIA issued the September 29 press release, the purported deal between MBIA and Zurich collapsed as a result of issues raised by MBIA's auditor. This ultimately led to significant changes in the written contracts, and to the secret side agreement between Axa and MBIA relating to Zurich.

51. The negotiations with Zurich began in August. By September 28, Zurich and MBIA had exchanged a draft that provided both excess of loss coverage on AHERF and a quota share feature. The most prominent feature of the initial draft was that the agreement limited Zurich's exposure by capping its losses on the quota share contract.

52. By mid-to-late October, MBIA's auditor advised that for the company to obtain the desired accounting treatment, the caps on Zurich's losses on the quota share had to be removed. However, MBIA senior executives knew that Zurich would not accept more risk.

53. Thus, by that time, there was no Zurich deal. However, in its September 29 press release, MBIA had already told the market that it had three reinsurers lined up to reimburse it for losses relating to AHERF. Accordingly, the CFO, with the CEO's knowledge and approval, set about salvaging the Zurich layer of the excess of loss by arranging for another reinsurer to assume the bulk of Zurich's risk on the quota share.

54. As it happened, the unraveling of the Zurich deal coincided with a planned gathering for MBIA and Axa senior executives at a resort in Portugal, which occurred from October 26 through 28. The CEO and CFO attended for MBIA, and Axa's CEO and Chief Operating Officer attended

along with its chairman, who was also the chairman and CEO of Axa's parent company.

55. In Portugal, the CFO approached Axa about assuming Zurich's risk under the quota share contract for a nominal premium. Axa said it would only do so if another reinsurer could be found to relieve it of that risk as it built on Axa's books, because even if the chance of paying out on those risks was low, Axa would be required to post reserves against the potential risk. During or shortly after the Portugal trip, the CFO and CEO assured Axa that MBIA would relieve Axa of the risk it had agreed to take on from Zurich. This side agreement was not reduced to writing and was not disclosed to MBIA's auditor.

56. In addition to the side agreement, Axa's agreement to take on Zurich's risk under the quota share contract resulted in three additional agreements because Zurich's payment under the excess of loss contract was to be funded by Interpolis Reinsurance Services, Ltd., a Dutch reinsurer. In exchange, Zurich gave to Interpolis the bulk of premiums it received from MBIA under the quota share contract, and Interpolis agreed to take on Zurich's risk from $13 million to $163 million. Axa took on this entire risk from Interpolis, through two separate agreements, one covering the risk from $13 million to $88 million, and the second covering the risk from $88 million to $163 million. In addition, Axa entered into a contract with Zurich under which it assumed Zurich's risk above $163 million. In return, Axa received $1 million in premium for each agreement, for a total of $3 million. In other words, Zurich and Interpolis retained $99 million in net premiums and retained only $13 million of the risk associated with those premiums, in exchange for the $70 million they provided MBIA to cover for the AHERF loss. Axa, on the other hand, assumed all the risk above $13 million for only $3 million in premium.

57. In short, the Zurich reinsurance arrangement involved limited transfer of risk to Zurich. Under the secret side agreement with MBIA, the risk under the quota share contract was

transferred back to MBIA, except for $13 million that was more than covered in full by the premiums that Zurich and Interpolis retained. In addition, by the time the deal was reached, there was no uncertainty or variability as to Zurich's payment under the excess of loss contract, because it was known by then that Zurich would have to pay the full amount of its commitment.

MBIA Created a Paper Trail to Justify Reinsurance Accounting

58. In order to obtain the auditor's approval for the desired accounting treatment, MBIA senior executives created a paper trail to justify the reinsurance accounting. This paper trail included several affirmative misrepresentations about the agreements, including but not limited to the following:

(a) First, MBIA represented that its estimate of its AHERF loss on the date on which it reached the reinsurance arrangements with Munich, Axa, and Zurich was less than the amount of excess of loss coverage agreed upon. Specifically, MBIA represented its estimate of loss at the time the reinsurance agreements were reached was $0-$117 million. This representation was false. By September 2, 1998, the earliest date by which MBIA claims the Munich and Axa agreements were purportedly in place, MBIA's surveillance department had estimated a loss of at least $95-100 million, and possibly as high as $150 million. The representation was also false with regard to Zurich because the deal that was in place in September was not the deal MBIA and Zurich ultimately entered into in October. By the time that deal was entered into, the AHERF loss was known to be at least $170 million.

(b) Second, the CEO and the CFO provided a letter for the auditor's files representing that

MBIA had "an agreement in principal [sic]" with Zurich, and that "[t]he principal terms were agreed to on September 22nd with the understanding that certain refinements needed to be made to comply with standard reinsurance and accounting practices." The CEO and CFO each knew when they signed the representation letter that the agreement ultimately reached with Zurich was fundamentally different than the one that was contemplated in September, and they knew that the auditor was unaware of the side agreement in which MBIA effectively agreed to take back all but $13 million of the risk it had ceded to Zurich under the quota share agreement.

MBIA's MISLEADING FINANCIAL STATEMENTS

59. MBIA recorded the $170 million Munich, Axa, and Zurich agreed to pay under the excess of loss contracts as a receivable in the third quarter of 1998, and its consolidated financial statements for the third quarter of 1998 and for the 1998 fiscal year included the entire amount as income.

60. In its November 3, 1998 earnings release, the company stated: "MBIA expects that any anticipated losses arising from [its AHERF exposure] will be fully covered by reinsurance. As a result, the company's third quarter earnings have not been affected by the bankruptcy." The release was filed on Form 8-K on November 4.

61. In its Form 10-Q for the quarter ended September 30, 1998, which was filed on November 16, 1998, MBIA stated that it had recorded "$198 million of reinsurance recoverables" for the AHERF loss, which included the $170 million receivable from Munich, Axa, and Zurich.

62. The recoverable under the purported reinsurance contracts, net of the nominal premium on those contracts, thus offset virtually the entire reported AHERF loss, which was recorded as an expense for the quarter. As a result, MBIA reported net income of approximately

$100 million for the third quarter and $432 million for the year ended December 31, 1998, and diluted earnings per share of $1.08 and $4.32 for the respective periods.

63. MBIA's financial statements and the above-quoted representations in its releases and filings were false and misleading because it was improper to recognize the $170 million as income and because MBIA did not disclose material facts that would have given the true picture of the transaction.

64. MBIA made these representations despite the fact that the CEO and CFO knew, or recklessly disregarded, that reinsurance accounting for the AHERF reinsurance arrangement was improper because there was no risk transfer under the excess of loss agreements and the reinsurers expected to be fully compensated for their payments under the excess of loss contracts by the quota share arrangements.

65. The AHERF reinsurance arrangement had a material and substantial impact on MBIA's reported earnings. Had the transaction been accounted for properly, as a financing, the $170 million receivable under the excess of loss contracts would not have been reported as income in 1998. The income statement effect was substantial: it would have resulted in at least $100 million less pre-tax income for the full year 1998 and, in the third quarter, would have resulted in MBIA's first quarterly loss. As a result of its fraudulent accounting for the recovery under the excess of loss contracts, MBIA was able to report that it "continu[ed] [its] unbroken streak of double-digit increases since [it] became a public company in 1987," as the company touted in its Annual Report for 1998.

MBIA Continued to Misrepresent Its Results for 1998

66. MBIA's misleading financial results for the 1998 third-quarter and fiscal year were republished in subsequent filings made in 1999, 2000, and 2001 and continued to create the false impression that the company had an uninterrupted succession of profitable quarters. Those filings

continued to conceal the true facts about the purported reinsurance recovery on AHERF, including the side agreement between MBIA and Axa.

67. It was not until March 2005, after Axa filed suit in France, that MBIA publicly acknowledged the side agreement and the effect of it on its reported results for 1998. In March 2005, MBIA restated its consolidated financial statements for the calendar years 1998 through 2003 in light of the conclusion reached in the course of the internal investigation that the existence of a side agreement "appear[s] likely." The effect on the company's consolidated income statement for the third quarter of 1998 and fiscal year 1998 was to reverse the $70 million gain attributable to the reinsurance receivable under the excess of loss contract with Zurich, which originally had offset part of the $170 million AHERF loss. MBIA also reversed the expense for the $102 million in net premiums it had ceded to Zurich, which it then recognized as income over a six-year period beginning in 1999. In addition, the company eliminated the $70 million receivable from Zurich originally reflected on its September 30, 1998 balance sheet.

68. The company did not restate its accounting for the other $100 million of reinsurance, which was improper.

FIRST CLAIM FOR RELIEF

(Violations of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act, and Rule 10b-5)

69. The Commission realleges and incorporates by reference herein each and every allegation contained in paragraphs 1 through 68, above.

70. As described above, defendant MBIA knowingly or recklessly made false and misleading statements, or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, to

purchasers and prospective purchasers of MBIA securities.

71. By reason of the foregoing, MBIA engaged, directly or indirectly, in transactions, acts, practices and courses of business which constitute violations of Section 17(a) of the Securities Act, 15 U.S.C. §§ 77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5.

SECOND CLAIM FOR RELIEF

(Violations of Section 13(a) of the Exchange Act and
Rules 12b-20, 13a-1, 13a-11, and 13a-13)

72. The Commission realleges and incorporates by reference herein each and every allegation contained in paragraphs 1 through 68, above.

73. As described above, MBIA failed to file with the Commission such financial reports as the Commission has prescribed, and failed to include, in addition to the information expressly required to be stated in such reports, such further material information as was necessary to make the statements made therein, in light of the circumstances in which they were made, not misleading.

74. By reason of the foregoing, MBIA violated Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a.1, 240.13a-11, and 240.13a-13.

THIRD CLAIM FOR RELIEF

(Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act)

75. The Commission realleges and incorporates by reference herein each and every allegation contained in paragraphs 1 through 68, above.

76. As described above, MBIA failed to make and keep books, records, and accounts

which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of its assets, and failed to maintain a system of internal accounting controls that permit the preparation of financial statements in conformity with GAAP.

77. By reason of the foregoing, MBIA violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:

1. Enter a Final Judgment:

a. directing defendant MBIA to disgorge ill-gotten gains from the fraudulent conduct alleged in this Complaint; and

c. directing defendant MBIA to pay civil monetary penalties pursuant to Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d), for the violations alleged herein.

2. Grant such other and further relief as the Court deems appropriate.

Dated: January 29, 2007
New York, New York

Respectfully Submitted,

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