

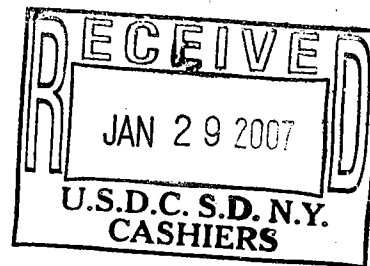
JUDGE KOELTL

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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.

<u>Counterparty</u>	<u>Excess of Loss Coverage</u>	<u>Quota Share Contract Gross Premiums</u>
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

