Exhibit C

FILED: NEW YORK COUNTY CLERK 09/23/2014 04:19 PM
INDEX NO. 652914/2014
NYSCEF DOC. NO. 2
RECEIVED NYSCEF: 09/23/2014

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

FINANCIAL GUARANTY INSURANCE COMPANY, Plaintiff, - against - MORGAN STANLEY ABS CAPITAL I INC., MORGAN STANLEY MORTGAGE CAPITAL HOLDINGS LLC, MORGAN STANLEY & CO. LLC, as successor to MORGAN STANLEY & CO. INC., MORGAN STANLEY, and SAXON MORTGAGE SERVICES, INC. Defendants.	Index No. **COMPLAINT**

Erik Haas (ehaas@pbwt.com)
Henry J. Ricardo (hjricardo@pbwt.com)
PATTERSON BELKNAP WEBB & TYLER LLP
1133 Avenue of the Americas
New York, NY 10036-6710
Telephone: (212) 336-2000
Fax: (212) 336-2222

Attorneys for Financial Guaranty Insurance Company

TABLE OF CONTENTS

Page

NATURE OF ACTION 1

THE PARTIES 6

JURISDICTION AND VENUE 9

FACTUAL ALLEGATIONS 10

I. Morgan Stanley Fraudulently Induces FGIC to Issue the Policy 10

A. Morgan Stanley Makes Misrepresentations to FGIC Concerning the Transaction and the Mortgage Loans 10

1. Morgan Stanley's Loan Diligence and Selection Process 14
2. Mortgage Loan Tapes and "Strats" 17
3. Offering Documents 19
4. Ratings 21

B. FGIC Reasonably Relied upon Morgan Stanley's Misrepresentations 22

II. The Parties Close the Transaction 25

III. Morgan Stanley Provides Warranties Concerning the Mortgage Loans and the Operations of Both Morgan Stanley and New Century 27

A. The Transaction Warranties 28

B. The Loan Warranties 32

IV. FGIC Discovers Pervasive Breaches of the Loan Warranties and Breaches of the Transaction Warranties 36

V. Morgan Stanley Frustrates the Repurchase Protocol by Repurchasing Only a Handful of Loans 39

VI. Repurchase Demands Made by the Trustee Corroborate FGIC's Findings of Breach 40

VII. An Order Entered by the SEC Corroborates FGIC's Findings of Breach of the Transaction Warranties 40

VIII. Saxon and MSAC Breached the PSA and a Related Side Letter Agreement 41

A. Saxon Failed to Provide Notice of Breaches of the Loan Warranties 42

B. Saxon Repeatedly and Systematically Failed to Comply with its Servicing Obligations under the PSA 45

1. Failure to Mitigate Losses 46
2. Delays in Foreclosures 48
3. Modification of Loans Not in Default 49
4. Extension of Mortgage Loan Maturity Dates Beyond the Maturity Date of the Certificates 52
5. Thwarted On-Site Visits 52
6. Saxon Breached the Side Letter Agreement to the PSA 53

C. Saxon and MSAC Breached the Warranties They Made in the PSA 54

1. Breaches of Saxon's Warranties Made in the PSA 54
2. Breaches of MSAC's Warranties Made in the PSA 56

IX. Morgan Stanley Discovered and Had Actual, Constructive and/or Inquiry Notice of Pool-Wide Loan Warranty Breaches 58

X. Public Filings Further Reveal the Improper Mortgage-Lending and Securitization Practices of New Century And Corroborate FGIC's Findings of Breach 59

XI. Public Filings Further Reveal Morgan Stanley's Improper Securitization Practices – and Corroborate FGIC's Findings 68

XII. FGIC Has Been Significantly Harmed 71

FIRST CAUSE OF ACTION 72

SECOND CAUSE OF ACTION 73

THIRD CAUSE OF ACTION 74

FOURTH CAUSE OF ACTION 75

FIFTH CAUSE OF ACTION 76

SIXTH CAUSE OF ACTION 76

SEVENTH CAUSE OF ACTION 78

PRAYER FOR RELIEF 78

Plaintiff Financial Guaranty Insurance Company ("FGIC"), through its attorneys, Patterson Belknap Webb & Tyler LLP, for its complaint against defendants Morgan Stanley ABS Capital I Inc. ("MSAC"), Morgan Stanley Mortgage Capital Holdings LLC ("MSMC"), Morgan Stanley & Co. LLC, as successor to Morgan Stanley & Co. Inc. ("MS&Co"), Morgan Stanley ("MS") (together with MSAC, MSMC and MS&Co, "Morgan Stanley"), and Saxon Mortgage Services, Inc. ("Saxon"), hereby alleges as follows:

NATURE OF ACTION

1. Morgan Stanley fraudulently induced FGIC to issue a financial guaranty insurance policy (the "Policy") guaranteeing payments due on certain securities issued in a Morgan Stanley securitization transaction known as MSAC 2007-NC4 (the "Transaction"). In addition, Morgan Stanley breached contractual warranties it provided to FGIC in connection with the Transaction attesting (i) to the quality and attributes of the loans it securitized in the Transaction, (ii) that the information provided to FGIC in advance of or relating to the Transaction was true, accurate, and complete, and (iii) that the offering documents prepared in connection with the Transaction were not materially untrue or misleading. Morgan Stanley's affiliate, Saxon, also breached its contractual warranties and other obligations in connection with the Transaction. FGIC brings this action to recover for the significant harm resulting from Morgan Stanley's fraud, and the material breaches of warranties and contractual obligations by Morgan Stanley and Saxon.

2. In early 2007, Morgan Stanley approached FGIC about the possibility of providing a financial guaranty on a mortgage-backed securitization transaction involving a group of residential mortgage loans originated by New Century Mortgage Corporation and its affiliates ("New Century"). Morgan Stanley was planning to acquire those loans through an upcoming

foreclosure auction, and transfer the servicing of those loans to Saxon. A "securitization" involves the sale of loans by a "sponsor" to a trust, which in turn issues securities to be paid down with the proceeds from the loans. The securities are marketed and sold to investors by securities underwriters, typically investment banks. In some cases, the securities are guaranteed by financial guarantors. In the case of the Transaction, Morgan Stanley solicited FGIC to guarantee payments due on the senior Class A certificates (the "Insured Securities") issued by the trust known as Morgan Stanley ABS Capital I Inc. Trust 2007-NC4 (the "Trust"), which were to be backed by – as represented by Morgan Stanley – a select pool of the New Century loans acquired by Morgan Stanley (the "Mortgage Loans").

3. More specifically, Morgan Stanley advised FGIC that it had carefully selected the pool of Mortgage Loans (the "Mortgage Pool") from a larger portfolio of loans originated by New Century. The Mortgage Pool, comprising approximately $1,051 million in aggregate principal amount of Mortgage Loans, supposedly represented a relatively low risk of default. Morgan Stanley represented to FGIC that Morgan Stanley had performed extensive loan-level due diligence to confirm the quality of the Mortgage Loans in connection with initially financing the origination of the Mortgage Loans and/or acquiring the Mortgage Loans through the foreclosure process. For example, Morgan Stanley represented that it reviewed approximately 50% of the Mortgage Loans to ensure that the originator of the loans, New Century, had complied with its loan origination guidelines and that any variations from such guidelines were made only if strong "mitigating factors" were present.

4. Furthermore, Morgan Stanley obtained and conveyed to FGIC ratings issued by rating agencies, ostensibly based on the same representations and information that Morgan Stanley had made and conveyed to FGIC. By these ratings, Morgan Stanley represented to FGIC

that Morgan Stanley had selected the Mortgage Loans and structured the Transaction to withstand and absorb a certain amount of the Transaction's potential losses under worst-case scenarios before FGIC would be obligated to pay any claims under its Policy.

5. In response to FGIC's demands, moreover, Morgan Stanley agreed to grant FGIC warranties attesting to the represented quality and attributes of the Mortgage Loans (the "Loan Warranties"). Morgan Stanley memorialized the Loan Warranties in the agreement pursuant to which the Mortgage Loans were transferred to MSAC before the transfer to the Trust (the "Representations and Warranties Agreement" or "R&W Agreement"). For FGIC's benefit, Morgan Stanley incorporated by reference the Loan Warranties into the agreement pursuant to which the Policy was issued (the "Insurance Agreement"). Also for FGIC's benefit, in the R&W Agreement and Insurance Agreement, Morgan Stanley committed and covenanted to repurchase any Mortgage Loans that did not comply with the Loan Warranties (the "Repurchase Agreement").

6. Moreover, by the terms of the Insurance Agreement, Morgan Stanley's commitments to FGIC were not limited to the Loan Warranties and FGIC's remedies were not limited to the Repurchase Protocol. Rather, the Insurance Agreement included additional, broader warranties from Morgan Stanley made exclusively for FGIC's benefit concerning the Transaction structure, the pool of Mortgage Loans as a whole, New Century's underwriting standards, and Morgan Stanley's operations (the "Transaction Warranties").

7. The Insurance Agreement also included incremental, broader, and cumulative remedies, afforded exclusively to FGIC, for breaches by Morgan Stanley or Saxon of their respective contractual warranties and covenants. Specifically, the Insurance Agreement entitled FGIC to exercise any and all remedies available "at law or in equity" upon a breach by Morgan

Stanley. In addition, to underscore the importance of Morgan Stanley's prompt compliance with its commitments, Morgan Stanley agreed to reimburse FGIC for, among other things, any and all fees and expenses (including attorneys' fees) that FGIC paid or incurred to enforce its rights under the Insurance Agreement, the R&W Agreement, and any other Transaction documents. The collective representations and warranties made by Morgan Stanley served to mitigate the potential risk of loss to FGIC.

8. The Mortgage Loans have defaulted at remarkable rates, resulting in substantial losses to the Transaction. As a result, FGIC is exposed to hundreds of millions of dollars in claims under the Policy. Faced with the mounting losses, FGIC retained consultants to conduct reviews of the Mortgage Loans for compliance with Morgan Stanley's representations and warranties.

9. The review conducted by FGIC's consultants revealed that all of the Mortgage Loans in a sample of hundreds of defaulted Mortgage Loans breached Morgan Stanley's representations and warranties. These findings, which were conveyed to Morgan Stanley, demonstrate overwhelmingly that the Mortgage Loans were originated in a manner that systematically ignored the borrowers' inability to repay the Mortgage Loans.

10. FGIC accordingly requested that Morgan Stanley repurchase those breaching Mortgage Loans. In willful disregard and frustration of its contractual obligations, however, Morgan Stanley has refused to repurchase all but a handful of the hundreds of breaching Mortgage Loans for which FGIC has provided notice.

11. Morgan Stanley similarly disregarded the repurchase demands made by the Trustee, Deutsche Bank, at the direction of Federal Home Loan Mortgage Corporation ("Freddie Mac"), which, as an owner of certain certificates issued by the Trust, independently undertook a

sample review of Mortgage Loans. Based on its review, Freddie Mac identified as breaching and the Trustee demanded that Morgan Stanley repurchase from the Trust at least 441 Mortgage Loans, with an original principal balance of $86.7 million. Morgan Stanley did not comply with the Trustee's repurchase demands.

12. The pervasive breach findings made by FGIC's consultants and Freddie Mac are consistent with and corroborated by an order entered by the Securities and Exchange Commission in July 2014 finding that Morgan Stanley made material misrepresentations concerning the Mortgage Pool in the offering document used to market the Transaction to investors, as well as by the allegations and evidence of breaches and misrepresentations by Morgan Stanley and New Century that are the subject of actions pending before this Court and other courts.

13. Had Morgan Stanley and New Century conducted their business in the manner represented, the Mortgage Pool would not have had so many defective loans, nor would the attributes of the Mortgage Loans been so dire, nor the loan-origination practices of New Century so flawed, as they were in actuality. Morgan Stanley's review of the Mortgage Loans would have -- and should have -- flagged the breaches and misrepresentations that FGIC's consultants and Freddie Mac identified.

14. The truth is that – contrary to Morgan Stanley's pre-contractual and contractual representations – Morgan Stanley disregarded the results of its reviews and diligence, and designated for securitization loans that it knew were defective. As reflected in the pervasiveness of the misrepresentations discovered by FGIC and others, Morgan Stanley had actual, constructive and/or inquiry notice that many of the Mortgage Loans were defective, and that the representations and warranties it was making in connection with the Mortgage Loans, and regarding the Transaction as a whole, were false.

15. Morgan Stanley's false and misleading representations and warranties induced FGIC to enter into the Insurance Agreement and issue the Policy, and materially increased FGIC's risk of loss thereunder. The Transaction has severely underperformed: As of August 2014, delinquencies were in excess of 37% of the current pool, approximately 66% of the active loans have been modified and collateral losses account for almost half of the deal at close. As a result, FGIC will be obligated to pay hundreds of millions of dollars of claims under its Policy. FGIC would not have entered into the Transaction, or incurred the claim payment obligation, had it known the truth.

16. The Transaction's underperformance has been increased, rather than mitigated, by the actions of Saxon as servicer after closing. Saxon both failed to provide notice of breaches of the Loan Warranties that it discovered in the course of servicing the Mortgage Loans, thereby concealing breaches by its Morgan Stanley affiliates, and failed to comply with its substantive obligations as servicer. FGIC's exposure to claims under its Policy has been increased by millions of dollars due to Saxon's deficient servicing practices.

17. Under New York common law and the New York Insurance Law, Morgan Stanley's fraud, and Morgan Stanley and Saxon's material breaches of their contractual obligations and breaches of material warranties, entitle FGIC to monetary relief, including, but not limited to, the recovery of the claims payments that FGIC is liable to make in the future under its Policy, and its fees, costs, and other expenses incurred in connection with the Transaction.

THE PARTIES

18. FGIC is a New York stock insurance corporation with its principal place of business at 125 Park Avenue, New York, New York 10017.

19. Defendant Morgan Stanley ABS Capital I Inc. ("MSAC") is incorporated under the laws of Delaware, and has its executive offices at 1585 Broadway, New York, New York 10036. MSAC served as the Depositor in the Transaction.

20. Defendant Morgan Stanley Mortgage Capital Holdings LLC ("MSMC") was formed under the laws of New York, and has its executive offices at 1585 Broadway, New York, New York 10036. MSMC served as the Sponsor of the Transaction. By virtue of a June 17, 2007 merger, Defendant MSMC became the successor-in-interest to Morgan Stanley Mortgage Capital, Inc. ("MSMCI"), which was the warehouse line provider to New Century, and ran the foreclosure auction for the Mortgage Loans.

21. Defendant Morgan Stanley & Co. LLC is a company organized under the laws of Delaware, is the successor to Morgan Stanley & Co. Inc. ("MS&Co"), a Delaware corporation, and has its principal place of business at 1585 Broadway, New York, New York, 10036. MS&Co served as the Underwriter of the Transaction.

22. Defendant Saxon Mortgage Services, Inc. ("Saxon") is incorporated under the laws of Texas, and has its executive offices at 4708 Mercantile Drive, Fort Worth, Texas 76137. Saxon served as the Servicer for the Transaction.

23. Defendant Morgan Stanley ("MS") is incorporated under the laws of Delaware, and has its executive offices at 1585 Broadway, New York, New York 10036. Defendant MS is the ultimate parent and sole owner of Defendants MSAC, MSMC, MS&Co and Saxon. As the corporate parent of MSAC, MSMC, MS&Co and Saxon, MS had the practical ability to, and in fact did, exercise direction and control of these subsidiaries in coordinating the securitization process, determining the structure of each offering, and issuing and selling the Insured Securities.

24. The Transaction involved MS-related entities at virtually each step in the process, and MS profited substantially from this vertically-integrated approach to mortgage-backed securitization. Furthermore, on information and belief, MS currently shares, and at all relevant times shared, overlapping management with the other Morgan Stanley entities. For instance, Craig S. Phillips was, at all relevant times, the Global Head of Securitized Products at MS while also serving as the President and CEO at MSAC. David R. Warren was, at all relevant times, the Global Head of Structured Credit Trading at MS while also serving as the President and Director at MSAC. Gail P. McDonnell was, at all relevant times, Managing Director and Head of the Securitized Products Group at MS&Co while also serving as Director at MSAC. Howard Hubler was, at all relevant times, Managing Director of the Proprietary Trading Group at MS while serving as Director at MSAC. Alexander C. Frank was, at all relevant times, Global Head of Institutional Operations at MS while also serving as Treasurer at MSAC. Steven Shapiro was, at all relevant times, a Vice President of MSMC, MSAC and MS&Co, and signed agreements to effectuate the Transaction on behalf of each of MSMC, MSAC and MS&Co in these capacities.

25. MS agreed to assume certain responsibilities based on the alleged acts and omissions of Saxon in a Consent Order, effective April 2, 2012, entered into with the Board of Governors of the Federal Reserve System. In the recitals to this Consent Order, MS acknowledged that, "MS, through Saxon, indirectly engaged in the business of servicing residential mortgage loans in the United States," that "MS, through Saxon, serviced residential mortgage loans" held in securitization trusts, and that "MS, through Saxon, had substantial responsibilities" in connection with servicing, including "the initiation and handling of foreclosure proceedings and loss mitigation activities." In order to ensure that "the consolidated

[MS] organization operates in a safe and sound manner," MS agreed to undertake various measures to remediate prior servicing misconduct that it engaged in "through Saxon."

26. MS also agreed to assume Saxon's liabilities when Saxon transferred its servicing obligations to Ocwen Financial Corporation in April 2012. According to Ocwen's SEC filing, MS agreed to retain "certain contingent liabilities for losses, fines and penalties arising from claims by and/or settlements with government authorities and certain third parties relating to [Saxon's] and its affiliates' pre-closing foreclosure, servicing and loan origination practices." Further, Saxon, MS and Ocwen agreed to share "certain losses arising out of third-party claims" in connection with Saxon's performance under its servicing agreements.

27. MS dominated and controlled its subsidiaries MSAC, MSMC, MS&Co and Saxon. MS used this dominion and control to perpetrate the fraud and breaches of contractual warranties and obligations alleged here. Accordingly, Defendant MS is responsible for the actions of Defendants MSAC, MSMC, MS&Co and Saxon as they relate to the Transaction.

JURISDICTION AND VENUE

28. This Court has personal jurisdiction over MSAC, MSMC, MS&Co, MS and Saxon pursuant to CPLR §§ 301, 302 and 311. Further, in the Insurance Agreement, MSAC, MSMC, and Saxon irrevocably submitted to the jurisdiction of any court in the State of New York located in the City and County of New York.[1]

29. Venue is proper in New York County pursuant to CPLR §§ 503(a) and 503(c) because each of MSAC, MSMC, MS&Co and MS has its principal office within New York

[1] Insurance Agreement § 6.05(a).

County and therefore is deemed to reside therein. Further, in the Insurance Agreement, MSAC, MSMC, and Saxon agreed to waive any defense of improper venue.[2]

FACTUAL ALLEGATIONS

I. MORGAN STANLEY FRAUDULENTLY INDUCES FGIC TO ISSUE THE POLICY

A. Morgan Stanley Makes Misrepresentations to FGIC Concerning the Transaction and the Mortgage Loans

30. In advance of closing and to induce its participation in the Transaction, FGIC received a mix of information concerning the Transaction and the Mortgage Loans. Morgan Stanley[3] made representations to FGIC about, among other things, the following four categories of information: (i) its loan review due diligence and selection process used to determine which Mortgage Loans would be included in the Transaction, (ii) the electronic files containing the attributes of the Mortgage Loans (referred to as the "Mortgage Loan Tape"), (iii) the offering documents, referred to as the term sheet, the Prospectus and the Prospectus Supplement ("ProSupp"), that had been used to market the Insured Securities, and (iv) the ratings for the Transaction issued by ratings agencies based on information Morgan Stanley compiled. Contrary to its representations and warranties in its contracts with FGIC that this information was true, Morgan Stanley knew, or recklessly disregarded, that the representations and information were false and misleading when made and conveyed to FGIC to induce it to issue the Policy.

31. It was particularly important to FGIC that Morgan Stanley, as the Sponsor of the Transaction, provide its broad representations and warranties in view of the circumstances leading

---

[2] Insurance Agreement § 6.05(a).

[3] The same individuals acted on behalf of MSAC, MSMC, MS&Co and MS. Indeed, the Underwriting Agreement between MSAC and MS&Co was signed by the same person, Steven Shapiro, acting for both entities. Mr. Shapiro was the same individual who first solicited FGIC's participation in the Transaction. On information and belief, the Morgan Stanley personnel with whom FGIC interacted were employees of MS and/or MS&Co, but also acted on behalf of MSAC and MSMC. Additionally, the same law firm represented MSAC, MSMC and MS&Co in the Transaction. This Complaint refers to these four Defendants as "Morgan Stanley," except where necessary to distinguish among them.

to this Transaction. By the time the Transaction was effectuated, Morgan Stanley had a long and intimate relationship with New Century and the Mortgage Loans.

32. Before 2007, Morgan Stanley and its affiliates routinely extended "warehouse" lines of credit to New Century whereby Morgan Stanley funded New Century's mortgage lending operations and obtained a security interest in the resulting mortgage loans. Morgan Stanley enabled New Century to move these loans off its balance sheet through multiple securitization transactions.

33. Morgan Stanley's longstanding relationship with New Century was a highly lucrative business for Morgan Stanley because it earned fees and other forms of revenue at every stage of the loan-origination and securitization process – in particular, warehouse fees, underwriting fees, and interest. Along the way, Morgan Stanley became intimately familiar with New Century's loan-origination practices and operations. On the other hand, by becoming so intertwined with New Century, Morgan Stanley also found itself increasingly exposed to New Century's credit risk. Indeed, New Century was among Morgan Stanley's largest warehouse lending clients and a major source of collateral for residential mortgage-backed securities sponsored and underwritten by Morgan Stanley.

34. By early 2007, Morgan Stanley and its affiliates had incurred large exposures to New Century, including multi-billion dollar warehouse lines of credit, which were secured by New Century's mortgage loans. At that time, New Century became engulfed in a series of scandals, including alleged accounting improprieties and criminal investigations. Morgan Stanley, as a warehouse lender to New Century, found itself even more exposed to New Century risk as a result of these scandals. On March 9, 2007, Morgan Stanley and its affiliates shut down

their credit lines to New Century and took steps to foreclose on the mortgage loans that served as collateral. Shortly thereafter, on April 2, 2007, New Century entered bankruptcy

35. Pursuant to the April 27, 2007 stipulated order entered by the bankruptcy court, MSMCI conducted an auction sale of thousands of New Century loans. One of the key provisions of this order afforded the bidders for the New Century loans the opportunity to conduct extensive due diligence concerning the mortgage loans. In fact, the stipulated order states that due diligence materials and a database established by MSMCI would be provided to qualifying bidders. The winning bidder of the auction was MSMC, which had the benefit of extensive knowledge of New Century's lending practices and business operations, and of the processes used by its affiliate to review New Century's lending practices. Subsequently, on June 17, 2007, prior to the closing of the Transaction, MSMCI merged into MSMC.

36. At approximately the same time, Saxon, another Morgan Stanley affiliate, became the servicer for these New Century loans. Accordingly, New Century transferred to Saxon the loan files and servicing records for its mortgage loans, most of which were originated several months before then and Saxon thus acquired full information as to the circumstances of the loans' origination and payment performance. As Servicer, Saxon not only had ready access to the loan files, but also daily contact with borrowers in connection with day-to-day servicing of the New Century loans. Saxon had started servicing the loans well before the Transaction closed. Morgan Stanley, as Saxon's affiliate, also had access to the loan files and servicing records for the New Century loans, including the Mortgage Loans.

37. According to its Vice President Steven Shapiro, even prior to the auction of the New Century loans, Morgan Stanley was already making preparations to sell these same loans through a series of securitization transactions, including the MSAC 2007-NC4 Transaction.

38. New Century's highly publicized scandals and bankruptcy made it difficult to attract investors for a securitization backed by mortgage loans originated by New Century. Morgan Stanley therefore approached FGIC in the first quarter of 2007 in the hope that a financial guaranty insurance policy would make a securitization of New Century mortgage loans more palatable to investors.

39. FGIC engaged in extensive discussions about the terms of a potential securitization transaction with Steven Shapiro, the Morgan Stanley Vice President. These discussions lasted for several months, beginning during the first quarter of 2007, before Morgan Stanley acquired the New Century loans, and ending with the closing of the Transaction on June 20, 2007. Mr. Shapiro sought FGIC's input on the terms that would be required to accomplish Morgan Stanley's objective of moving these New Century loans off its balance sheet.

40. But FGIC shared the same concerns regarding New Century loans as the market generally. Accordingly, FGIC told Morgan Stanley that FGIC required certain assurances and commitments from Morgan Stanley relating to the New Century loans as a condition of FGIC's participation in the Transaction. For example, FGIC told Morgan Stanley that it required Morgan Stanley's commitment that it would review the New Century loans. In response, Mr. Shapiro represented that, when Morgan Stanley acted as the sponsor of a residential mortgage-backed securities ("RMBS") transaction, it conducted extensive loan-level review of the mortgage loans included in the collateral pool. Mr. Shapiro further represented – in numerous conversations prior to FGIC's commitment to participate in the Transaction – that Morgan Stanley would conduct an even more extensive review of the New Century loans in connection with its acquisition of the loans through the foreclosure action. In particular, Mr. Shapiro represented that Morgan Stanley

would review approximately 50% of the loans, and use that due diligence review to select only the best mortgage loans for inclusion in the Transaction.

41. FGIC also told Morgan Stanley that it would be critical to transfer servicing of the New Century loans to an experienced, high-quality servicer. In response, Mr. Shapiro provided assurances that Morgan Stanley would transfer servicing to Saxon, its affiliate. Saxon had a strong reputation at the time, and Mr. Shapiro assured FGIC that transferring servicing to Saxon would improve the performance of the collateral and be beneficial to all participants in the Transaction, including FGIC.

42. FGIC also demanded as a condition of its participation in the Transaction that Morgan Stanley provide written representations and warranties regarding the quality and attributes of the Mortgage Loans and the processes that Morgan Stanley undertook to assure the quality of the loans. FGIC required absolute clarity that Morgan Stanley bore the risk of loss in the event the representations and warranties were false or misleading.

43. Morgan Stanley acceded to FGIC's demands to induce FGIC's participation in the Transaction. Morgan Stanley agreed to provide and did provide to FGIC Loan Warranties and Transaction Warranties. As discussed below, the Transaction Warranties attested to the veracity of, among other things, the following four categories of representations Morgan Stanley made before the closing of the Transaction concerning the Mortgage Loans and business practices employed by both New Century and Morgan Stanley. FGIC would not have participated in the Transaction or issued the Policy had Morgan Stanley not provided these representations and warranties or if it had known that they were untrue.

1. Morgan Stanley's Loan Diligence and Selection Process

44. Morgan Stanley represented to FGIC that it had conducted extensive due diligence on the Mortgage Loans in its role as warehouse lender to New Century. More

specifically, Mr. Shapiro represented to FGIC that Morgan Stanley had reviewed approximately 50% of the loan files in the Transaction, which was more diligence than Morgan Stanley typically conducted in a securitization, and that it used this diligence process to weed out the more risky loans, leaving only a "cherry-picked" subset of the best New Century loans available for securitization.

45. Additionally, Morgan Stanley represented that it had acquired the Mortgage Loans in accordance with a bankruptcy court stipulation providing for, and after conducting, additional diligence. Specifically, via the stipulated order Morgan Stanley had access to the following information about the mortgage pool:

- Exception reports with respect to the Mortgage Loans prepared by Deutsche Bank National Trust Company;
- Due diligence materials and a database established by MSMCI; and
- Additional loan-level documentation related to the Mortgage Loans.

46. After participating in two separate stages of diligence concerning the Mortgage Loans, Mr. Shapiro of Morgan Stanley represented that the Mortgage Loans securitized in the Transaction were markedly better than the pools of loans that had been the subject of earlier securitization transactions involving New Century mortgage loans.

47. Moreover, Mr. Shapiro told FGIC that it was this diligence and selection process that enabled Morgan Stanley to provide FGIC with detailed representations and warranties about the Mortgage Loans and the processes by which they were originated. The fact that Morgan Stanley was willing to make such representations and warranties about these New Century loans and the integrity of the data provided to FGIC in connection with the Transaction, which placed both Morgan Stanley's financial wherewithal and professional reputation at stake, was a major factor that induced FGIC to agree to participate in the Transaction.

48. Morgan Stanley's pre-contractual representations to FGIC about the nature and extent of its loan-level due diligence were consistent with other statements made by Morgan Stanley about its diligence process at the time, *i.e.*, that diligence was intended to weed out loans having attributes that were inconsistent with the descriptions provided and representations made about them. Morgan Stanley continued to describe its diligence process in this way even after the onset of the financial crisis. In statements made to the Congressional Financial Crisis Inquiry Commission, through its then-CEO, John Mack, Morgan Stanley asserted that the primary purpose of its due diligence practices before the financial crisis was to ascertain whether the loans that Morgan Stanley purchased materially conformed to the seller's description of them. Mr. Mack further explained that the loan-level diligence that Morgan Stanley performed included valuation diligence, credit diligence and compliance diligence. With respect to credit diligence, Mr. Mack asserted that it included a review of whether any exceptions to underwriting guidelines were supported by compensating factors.

49. Morgan Stanley's pre-contractual representations regarding its diligence processes were false and misleading. Based on Morgan Stanley's sophistication and the pervasiveness of the defects later found by FGIC's consultants, it is clear that Morgan Stanley knew the poor quality of the Mortgage Loans, but concealed that information from FGIC. Furthermore, as described in Section XI below, public sources have revealed that Morgan Stanley subverted its diligence process by overriding determinations by its outside vendors that loans were defective, and knowingly selling defective loans to securitization trusts. Instead of using the diligence process to keep bad loans out of securitization trusts, Morgan Stanley used the findings of its third-party vendors to negotiate discounts from the loan originators ***for itself***, but not for the trusts to which the defective loans had been sold. By concealing the true facts about its diligence

process, Morgan Stanley's representation that it conducted a loan-file review in order to screen out risky loans was materially false and misleading.

50. Morgan Stanley knew that these representations, which concerned its own diligence process, were false when made. If FGIC had known that these pre-contractual representations were false and misleading, it would not have agreed to participate in the Transaction and to issue its Policy.

2. Mortgage Loan Tapes and "Strats"

51. By email dated May 23, 2007, Morgan Stanley sent to FGIC an electronic file referred to as the "Mortgage Loan Tape" that contained data for the Mortgage Loans. In the same email, Morgan Stanley sent FGIC a second file, referred to as the collateral "Strats," which highlighted certain aspects of the data for the Mortgage Loans. The data disclosed in the Mortgage Loan Tape included the following attributes of the Mortgage Loans:

- the loan-to-value ratio ("LTV") for each loan, which compared the loan amount to the appraised value of the mortgaged property;
- the combined loan-to-value ratio ("CLTV") for each loan, which measured the total amount of mortgage debt that encumbered a property against the appraised value of the property;
- the FICO (or credit) score for each borrower, which measures the credit worthiness of the borrower;
- the occupancy status of the mortgaged property, which listed whether the property was the borrower's primary or secondary residence, or an investment property;
- the "doc-type" of each loan, which described the program pursuant to which the loan was originated (which determined the information and documentation that borrowers were required to provide concerning their income, employment, and assets, and how such information would be verified); and
- the credit grade given to each loan by New Century pursuant to its underwriting guidelines, which assesses the likelihood that the borrower will be able to repay his or her mortgage loan.

52. Morgan Stanley intended for FGIC to rely on the data in the tape to evaluate whether to participate in the Transaction. Morgan Stanley knew it was standard practice for financial guarantors and other securitization participants, including the rating agencies, to use the data provided on mortgage-loan tapes in their credit-risk analysis of securitizations, including using data extracted from the mortgage-loan tapes as inputs for models used to calculate loss curves associated with the related mortgage-loan pools. Morgan Stanley knew and intended that FGIC would accept as true, complete, and accurate the data disclosed in the Mortgage Loan Tape and had agreed that Morgan Stanley would bear the risk of loss if that data were false or misleading. Consistent with that understood and reasoned risk allocation, FGIC demanded and Morgan Stanley agreed that it would provide a warranty in the Insurance Agreement that the information conveyed on the Mortgage Loan Tape was not false or misleading.[4]

53. As Morgan Stanley intended, FGIC relied on the veracity of the data provided in the Mortgage Loan Tape to decide whether to participate in the Transaction. The disclosed attributes were critical to assessing the risk that the Mortgage Loans would default – and were therefore material to the value of the Mortgage Loans that served as collateral. Accordingly, FGIC's due diligence included reviewing and assessing the attributes of the Mortgage Loans, as represented on the Mortgage Loan tape received by FGIC, and then modeling the expected performance of the Transaction, assuming for purposes of these analyses the veracity of, and using as inputs, the data and attributes disclosed. The veracity of the data in the Mortgage Loan Tape was material to FGIC's analysis of the Transaction, and FGIC would not have entered into the Insurance Agreement or issued the Policy had it known that such data – contrary to Morgan Stanley's warranties – was false or misleading.

[4] *See* Insurance Agreement § 2.01(k) ("Accuracy of Information").

54. As evidenced by the loan data reviews conducted by FGIC's consultants, the data provided to FGIC in the Mortgage Loan Tape – though warranted by Morgan Stanley to be true – was materially false and misleading. The loan reviews indicate pervasive and material misstatements in the data disclosed. The misstatements contained in the Mortgage Loan Tape materially increased FGIC's risk of loss from agreeing to participate in the Transaction and to issue its Policy.

55. Given Morgan Stanley's extensive knowledge of New Century's lending practices, the diligence that Morgan Stanley conducted, and the pervasiveness of the defects that FGIC later discovered, it is inconceivable that Morgan Stanley did not know that the loan data it provided to FGIC was false at the time when Morgan Stanley provided it.

3. Offering Documents

56. FGIC also received a Prospectus Supplement (or "ProSupp") for the Transaction.[5] This document contains descriptions of the underwriting guidelines used by New Century to originate the Mortgage Loans and statements that the Mortgage Loans were generally originated in compliance with those guidelines. It also contains a description of Morgan Stanley's processes for conducting diligence concerning mortgage-loan originators such as New Century and other information about the Transaction and the participants in the Transaction. Morgan Stanley intended for FGIC, as well as investors in the Transaction, to rely on the representations in the ProSupp.

57. The ProSupp does not describe any individual Mortgage Loan, but instead contains representations about the aggregate characteristics of the Mortgage Pool for the

[5] Morgan Stanley transmitted the final ProSupp to FGIC on June 19, 2007, before the closing of the Transaction. Before that, Morgan Stanley had transmitted substantially the same factual information to FGIC in the form of drafts of the ProSupp and the final Free Writing Prospectus for the Transaction, which Morgan Stanley sent to FGIC on June 14, 2014.

Transaction, including disclosures about the CLTV ratios and occupancy rates. For example, the ProSupp asserts that the mortgaged properties in the underlying collateral pool are at least 90% owner-occupied and that no mortgage loan has a CLTV greater than 100%.

58. The reviews conducted by FGIC's consultants have revealed that these representations made in the ProSupp were false and misleading. In fact, the aggregated characteristics of the Mortgage Pool were materially different from the assertions made in the ProSupp. Corroborating FGIC's findings, the Securities and Exchange Commission (the "SEC") issued an order on July 24, 2014 finding certain statements in the ProSupp to be materially false and misleading. Additionally, given the pervasiveness of the defects found by FGIC's consultants, the statements about the Mortgage Loans being originated in accordance with prudent underwriting standards and about Morgan Stanley's use of its diligence process to ensure the quality of the Mortgage Loans were false and misleading.

59. Based upon its long-standing and intimate knowledge of New Century's lending practices and loans, Morgan Stanley knew the poor quality of the Mortgage Loans, but included them in the Transaction anyway. Morgan Stanley likewise knew that the ProSupp was false and misleading in its descriptions of New Century's guidelines, the Mortgage Pool as a whole, and Morgan Stanley's processes and procedures for ensuring the quality of the Mortgage Loans included in the Transaction.

60. The ProSupp's false and misleading statements about New Century's compliance with underwriting guidelines, the attributes of the Mortgage Pool as a whole, and Morgan Stanley's diligence processes materially increased FGIC's risk of loss from agreeing to issue its Policy. Had FGIC known that these and related disclosures in the ProSupp were false – *i.e.*, had

it known that Morgan Stanley's warranties about the truth of those disclosures were also false – it never would have issued its Policy.

4. Ratings

61. FGIC also received so-called "shadow ratings" for the Transaction by Standard & Poor's Rating Services ("S&P"), Fitch, Inc. ("Fitch") and Moody's Investors Service, Inc. ("Moody's"). The "shadow ratings" were private ratings that the agencies would assign to RMBS, determined without consideration of the protection afforded by a financial guaranty insurance policy. Shadow ratings were dependent on analyses of both the underlying mortgage loans and the structure of the rated securities, including, among other things, the amount of "loss coverage" built into the deal, *i.e.*, the amount of losses the deal could absorb without impairing the principal or interest payments on the rated security (again, without consideration of the financial guaranty insurance policy). The shadow ratings for the Transaction were false and misleading, however, and Morgan Stanley knew they were false and misleading, because, upon information and belief, they were based directly or indirectly on the same false data that were in the Mortgage Loan Tape provided to FGIC.

62. Morgan Stanley intended for FGIC to rely on the purported accuracy of the ratings in deciding whether to participate in the Transaction. From its frequent participation in RMBS transactions, Morgan Stanley knew that shadow ratings were required by financial guarantors to assess the riskiness of securities proposed to be insured, and of the underlying mortgage-loan pools offered as collateral, and to determine the amount of capital required to be allocated to the insurance of such securities for rating-agency purposes. In fact, FGIC relied on the ratings for those very purposes in connection with the Transaction.

63. Reflecting the significance of shadow ratings to its determination of whether to participate in the Transaction, FGIC demanded and received Morgan Stanley's express agreement

in the Insurance Agreement that a condition precedent to the issuance of the Policy was FGIC's receipt of confirmation that the insured securities had received from S&P, Fitch, and Moody's at least the shadow ratings previously conveyed by Morgan Stanley.[6] The fact that the shadow ratings were based on false and misleading information materially increased FGIC's risk of loss from agreeing to participate in the Transaction and to issue its Policy. Had FGIC known that the ratings issued by S&P, Fitch and Moody's were false and misleading, or were procured based upon false and misleading information – *i.e.*, that Morgan Stanley's warranties to the contrary were false – FGIC would not have entered into the Insurance Agreement or issued its Policy.

B. FGIC Reasonably Relied upon Morgan Stanley's Misrepresentations

64. As particularized in the preceding sections, Morgan Stanley knowingly and with the intent to induce reliance thereon made material misrepresentations to FGIC prior to the closing of the Transaction, and actively concealed material information pertaining to the Mortgage Loans and Morgan Stanley's operations. FGIC relied to its detriment on Morgan Stanley's false and misleading representations and omissions.

65. FGIC's reliance on Morgan Stanley's pre-closing representations was reasonable and consistent with the industry practice and the parties' bargain. As was the general practice and the parties' agreement, Morgan Stanley and FGIC assumed risk and undertook due diligence consistent with their respective roles in the Transaction.

66. Morgan Stanley and/or its affiliates – as the Sponsor and Depositor for the Transaction – assumed the risk and the burden of assessing the validity of the attributes of the Mortgage Loans conveyed to the Trust, including that the Mortgage Loans were originated

---

[6] *See* Insurance Agreement § 3.01(l) (stating that a condition precedent for the issuance of the Policy is that FGIC "shall have received confirmation that the Insured Certificates are rated "at least 'AA' by S&P and Fitch and 'A1' by Moody's, in each case without regards to the Certificate Insurance Policy.")

pursuant to the appropriate underwriting guidelines. FGIC, as the insurer, bore the credit risk of the Insured Securities, and assumed the burden of evaluating whether the Mortgage Loans, ***given that they bore the attributes represented to FGIC and warranted by Morgan Stanley to be true***, would experience greater loss or delinquency after the closing of the Transaction than the structure of the Transaction would be able to absorb.

67. The allocation of risk between Morgan Stanley and FGIC was a reasoned risk allocation, reflecting the roles of, and the information available to, the two parties.

68. Morgan Stanley had previously financed New Century's mortgage-lending operations, extending credit to New Century and obtaining a security interest in the very same loans that were selected for the Transaction. Thus, Morgan Stanley had sufficient information to confirm the accuracy of the statements in the ProSupp concerning New Century's loan-origination guidelines, which Morgan Stanley had described for investors in numerous previous securitization transactions.

69. Morgan Stanley also purchased at auction, and therefore owned, the Mortgage Loans and the related loan files, which afforded it access to and control over all of the information in those loan files. Even before it purchased the Mortgage Loans, the bankruptcy court order authorizing the auction provided for extensive diligence concerning New Century and the loans that were for sale. In fact it was MSMCI that conducted the auction and provided due diligence materials to prospective bidders. At approximately the same time Saxon, another Morgan Stanley affiliate, became the servicer of the Mortgage Loans, assuming day-to-day responsibility for them well before the closing of the Transaction, and therefore acquired the servicing records for the Mortgage Loans as well. Thus, Morgan Stanley had sufficient information to evaluate the Mortgage Loans, and to confirm the accuracy of the information that it later provided to FGIC.

Indeed, only by purposely shutting its eyes to the information in its hands could Morgan Stanley have avoided actual knowledge of the true circumstances and characteristics of the Mortgage Loans.

70. In contrast, FGIC was not in privity with and lacked recourse against New Century, never owned any of the Mortgage Loans or the related loan files, and therefore did not have the legal right to review the Mortgage Loan files before deciding whether to participate in the Transaction. Nor did Morgan Stanley share with FGIC any such loan files prior to the Transaction. FGIC therefore could not have known, prior to the Transaction, the information that Morgan Stanley was withholding concerning the Mortgage Loans.

71. It therefore made sense for the sophisticated parties to agree that Morgan Stanley would bear the risk that the represented loan data was false or misleading, and that FGIC, relying on the truth of the representations it received, would bear the credit risk associated with the Transaction as represented – *i.e.*, the credit risk associated with a transaction that actually ***did*** have the attributes that the Transaction was represented to have. The warranties that Morgan Stanley provided were the means by which the parties memorialized and effectuated the reasoned risk allocation and, therefore, were an essential inducement for FGIC to participate in the Transaction and issue the Policy. In particular, they gave FGIC comfort – both practically and as a matter of law – that even though it could not reasonably conduct its own review of the loan files for the Mortgage Loans and the underwriting practices followed in originating them, FGIC did not need to because, by securing contractual warranties, it was purchasing Morgan Stanley's assurance of the truth of its representations and the legal right to rely on them and be held harmless if such warranties were untrue.

II. The Parties Close the Transaction

72. The Transaction closed on June 20, 2007 and involved the securitization of mortgage loans originated by New Century.

73. As the Sponsor of the Transaction, MSMC pooled and securitized approximately 5,337 residential mortgage loans with an aggregate principal balance of approximately $1,051 million, which Morgan Stanley or its affiliates had previously purchased through a foreclosure auction. MSMC in turn transferred the Mortgage Loans to its affiliate, MSAC, which then transferred them to the Trust. The Mortgage Loans served as collateral for the issuance of approximately $1,051 million in securities. FGIC guaranteed the payment of the principal of and interest on the Insured Securities (the Class A Certificates), which had an original aggregate outstanding principal balance of approximately $876 million.

74. The Transaction was effectuated through the following series of agreements executed by Morgan Stanley and its affiliates, with the same individual, Morgan Stanley Vice President Steven Shapiro, signing for MSMC, MSAC and MS&Co. The same law firm, Cadwalader, Wickersham & Taft LLP, represented all three of these Morgan Stanley entities in the Transaction. The agreements governed, among other things, the rights and obligations of the various parties with respect to the Mortgage Loans and the securities issued in connection with the Transaction.

75. MSMC, acting as Sponsor, sold and assigned the Mortgage Loans to its affiliate MSAC pursuant to a Bill of Sale dated as of June 20, 2007. Steven Shapiro executed the Bill of Sale on behalf of both parties, the Sponsor and the Depositor. In connection with this sale and the securitization transaction, the Sponsor made certain representations and warranties regarding the Mortgage Loans in the separate R&W Agreement, dated as of June 20, 2007. Steven Shapiro executed the R&W Agreement on behalf of both parties, the Sponsor and the Depositor. The

Loan Warranties, which were made by MSMC under the R&W Agreement, attest to the characteristics of the Mortgage Loans. Accompanying the Loan Warranties is a protocol obligating MSMC to repurchase any Mortgage Loan for which a breach of warranty is discovered.

76. Pursuant to the Pooling and Servicing Agreement, dated as of May 1, 2007 (the "PSA"), the Depositor assigned the Mortgage Loans to the Trust. Steven Shapiro executed the PSA on behalf of the Depositor. The Trust then issued several classes of securities with an aggregate principal balance of $1,051 million, including the Class A Certificates (*i.e.*, the Insured Securities), with an aggregate principal balance of $876 million. Saxon agreed to act as Servicer for the Mortgage Loans, agreeing in Section 2.07 of the PSA that, upon discovery of any breaches of any representation or warranty made by MSMC in the R&W Agreement, Saxon would provide prompt written notice thereof to the parties to the PSA and to MSMC.

77. MS&Co, acting as Underwriter, was responsible for underwriting the sale of the Certificates and managing its offering to investors. MS&Co drafted or reviewed the Offering Documents, including the disclosures and representations in the ProSupp, and had provided drafts of them to FGIC before the closing of the Transaction. Steven Shapiro executed the Underwriting Agreement on behalf of both the Underwriter and the Depositor.

78. To enhance the credit rating and marketability of the Insured Securities and its return on the Transaction, Morgan Stanley sought an insurance policy from FGIC guaranteeing the principal and interest payments due to holders of the Insured Securities. As a condition precedent to the Policy's issuance and as an inducement to FGIC, Morgan Stanley entered into the Insurance Agreement with FGIC. In the Insurance Agreement, Morgan Stanley and Saxon made numerous representations and warranties concerning, among other things, the Mortgage

Loans and its operations to and for the benefit of FGIC, and incorporated and repeated therein each of the Loan Warranties set forth in the R&W Agreement. Morgan Stanley also agreed to afford FGIC broad and non-exclusive remedies, such as any relief "existing at law or in equity," and to reimburse FGIC for any fees, costs, and expenses incurred by FGIC in defending and enforcing its rights in connection with the Transaction, including its rights under the Insurance Agreement and the R&W Agreement.

79. Relying on, among other things, Morgan Stanley's pre-contractual representations and the representations, warranties, disclosures, statements, covenants, and remedies contained in and encompassed by the Insurance Agreement and the R&W Agreement, FGIC issued Financial Guaranty Insurance Policy Number 07030039. By its Policy, FGIC agreed to guarantee certain principal and interest payments due to the holders of the Class A Certificates.

III. MORGAN STANLEY PROVIDES WARRANTIES CONCERNING THE MORTGAGE LOANS AND THE OPERATIONS OF BOTH MORGAN STANLEY AND NEW CENTURY

80. Morgan Stanley made two types of contractual representations and warranties to implement the parties' negotiated risk allocation and to induce FGIC to issue its Policy. The Transaction Warranties concerned, generally, the attributes of the Mortgage Pool and the truthfulness of the information provided to FGIC about Morgan Stanley's finances, New Century's mortgage-lending operations, practices, and protocols, and Morgan Stanley's practices and protocols that it used to perform diligence concerning mortgage lenders such as New Century. The Loan Warranties concerned the characteristics of each individual Mortgage Loan that was securitized. Morgan Stanley's certification as to the truth of the Transaction Warranties and the Loan Warranties was an express condition precedent to FGIC's issuance of the Policy.[7]

[7] *See* Insurance Agreement § 3.01(f) (listing the truth and correctness of Morgan Stanley's representations and warranties as among several "conditions precedent" to the issuance of FGIC's Policy).

A. The Transaction Warranties

81. The Transaction Warranties were made in Section 2.01 of the Insurance Agreement and include, in relevant part, the following:

> (k) *Accuracy of Information.* None of the material information relating to the Mortgage Loans or the operations of the Sponsor, the Depositor or the Servicer . . . furnished to the Certificate Insurer in writing or in electronic form . . . including, without limitation, the electronic tape containing statistical data with respect to the Mortgage Loans (collectively, the "Documents"), contains any statement of a material fact which was untrue or misleading in any material respect when made. None of the Sponsor, the Depositor or the Servicer has any knowledge of any circumstances that could reasonably be expected to cause the Documents to include a statement of material fact which is untrue or misleading . . . .
>
> (m) *Compliance with Securities Laws.* The offer and sale of the Certificates complies in all material respects with all requirements of law . . . . Without limiting the foregoing, the Offering Documents . . . do not contain any untrue statement of a material fact and do 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 . . . .

82. The ProSupp, which was one of the Offering Documents, made the following statements about the processes and general business practices pursuant to which the Mortgage Loans were originated.

> *Underwriting Standards.* The mortgage loans originated or acquired by New Century were done so in accordance with the underwriting guidelines established by it (collectively, the "New Century Underwriting Guidelines"). The following is a general summary of the New Century Underwriting Guidelines believed to be generally applied, with some variation, by New Century. This summary does not purport to be a complete description of the underwriting standards of New Century. The New Century Underwriting Guidelines are primarily intended to assess the borrower's ability to repay the related mortgage loan, to assess the value of the mortgaged property and to evaluate the adequacy of the property as collateral for the mortgage loan. All of the mortgage loans were also underwritten with a view toward the resale of the mortgage loans in the secondary mortgage market.

> While New Century's primary consideration in underwriting a mortgage loan is the value of the mortgaged property, New Century also considers, among other things, a borrower's credit history, repayment ability and debt service-to-income ratio, as well as the type and use of the mortgaged property.
>
> * * *
>
> The mortgage loans will have been originated in accordance with the New Century Underwriting Guidelines. On a case-by-case basis, exceptions to the New Century Underwriting Guidelines are made where compensating factors exist.[8]

83. Additionally, the ProSupp described the documentation that New Century purportedly required prospective borrowers to produce in order to obtain a mortgage loan.

> Each applicant completes an application that includes information with respect to the applicant's liabilities, income, credit history, employment history and personal information. The New Century Underwriting Guidelines require a credit report on each applicant from a credit reporting company. The report typically contains information relating to matters such as credit history with local and national merchants and lenders, installment debt payments and any record of defaults, bankruptcies, repossessions or judgments.

84. The ProSupp also described the property appraisal standards and practices supposedly employed by New Century.

> Mortgaged properties that are to secure mortgage loans generally are appraised by qualified independent appraisers. These appraisers inspect and appraise the subject property and verify that the property is in acceptable condition. Following each appraisal, the appraiser prepares a report that includes a market value analysis based on recent sales of comparable homes in the area and, when deemed appropriate, replacement cost analysis based on the current cost of constructing a similar home. All appraisals are required to conform to the Uniform Standards of Professional Appraisal Practice adopted by the Appraisal Standards Board of the Appraisal Foundation and are generally on forms acceptable to Fannie Mae and Freddie Mac. The New Century Underwriting Guidelines require a review of the appraisal by a qualified

[8] ProSupp at S-42.

> employee of New Century or by an appraiser retained by New Century.

85. The ProSupp further represented that there was general compliance with underwriting guidelines requiring an analysis of the borrower's ability to repay the loan:

> The mortgage loans were originated consistent with and generally conform to the New Century Underwriting Guidelines' full documentation, limited documentation and stated income documentation residential loan programs. Under each of the programs, New Century reviews the applicant's source of income, calculates the amount of income from sources indicated on the loan application or similar documentation, reviews the credit history of the applicant, calculates the debt service-to-income ratio to determine the applicant's ability to repay the loan, reviews the type and use of the property being financed, and reviews the property. In determining the ability of the applicant to repay the loan, a qualifying rate has been created under the New Century Underwriting Guidelines that generally is equal to the interest rate on that loan. The New Century Underwriting Guidelines require that mortgage loans be underwritten in a standardized procedure which complies with applicable federal and state laws and regulations and requires New Century's underwriters to be satisfied that the value of the property being financed, as indicated by an appraisal and a review of the appraisal, currently supports the outstanding loan balance.

86. The ProSupp also made statements describing Morgan Stanley's review and screening processes to determine whether to acquire mortgage loans for securitization. For example, the ProSupp stated:

> Prior to acquiring any residential mortgage loans, [Morgan Stanley] conducts a review of the related mortgage loan seller that is based upon the credit quality of the selling institution. [Morgan Stanley's] review process may include reviewing select financial information for credit and risk assessment and conducting an underwriting guideline review, senior level management discussion and/or background checks. The scope of the mortgage loan due diligence varies based on the credit quality of the mortgage loans.

> The underwriting guideline review entails a review of the mortgage loan origination processes and systems. In addition, such review may involve a consideration of corporate policy and procedures relating to state and federal predatory lending, origination practices by jurisdiction, historical loan level loss experience, quality control practices, significant litigation and/or material investors.

87. With respect to the qualities of the Mortgage Loans in aggregate, the ProSupp made, among others, the following representations:

> None of the mortgage loans have loan-to-value ratios at origination, or with respect to second-lien mortgage loans, combined loan-to-value ratios at origination, in excess of 100%.
>
> 41 mortgage loans with an aggregate principal balance as of the cut-off date of $10,501,930.24, which represents approximately 0.9994% of the mortgage loans in the final mortgage loan pool, were more than 30 days but less than 60 days Delinquent with respect to their scheduled monthly payments.

88. As the foregoing provisions illustrate, the Transaction Warranties broadly attest that the information provided to FGIC -- concerning the Mortgage Loans in aggregate, New Century's mortgage-lending operations, and Morgan Stanley loan-securitization practices (*e.g.*, its loan-acquisition policies and practices, including its due-diligence practices and underwriting guidelines, and its quality-control policies and practices), and the representations used to market the Insured Securities (*e.g.*, the disclosures in the ProSupp) -- was true, accurate, and complete. These warranties are not qualified by any knowledge requirement. Any material misstatement or omission with respect to such disclosures therefore is a breach of these provisions, ***irrespective*** of whether Morgan Stanley knew or intended such misstatement or omission. Many such misstatements and omissions are detailed in this Complaint, including in Sections IV (describing the results of FGIC's review of a sample of hundreds of mortgage loans) and XI (describing public evidence of Morgan Stanley's subversion of the diligence process) below.

89. A breach of any Transaction Warranty constitutes an "Event of Default" under Section 5.01(a) of the Insurance Agreement. Upon an "Event of Default," Section 5.02(a) of the Insurance Agreement entitles FGIC to, among other things, "take whatever action at law or in equity as may appear necessary or desirable in its judgment" to redress Morgan Stanley's breaches.

B. The Loan Warranties

90. The Loan Warranties were made in Section 2 and Exhibit I of the R&W Agreement and were explicitly incorporated by reference into the Insurance Agreement. Specifically, Section 2.01(n) of the Insurance Agreement provides as follows:

> *Operative Documents*. Each of the representations and warranties of the Sponsor, the Servicer and the Depositor contained in the applicable Operative Documents to which it is a party is true and correct as of the date reflected therein and each of the Sponsor, the Servicer and the Depositor hereby makes each such representation and warranty to, and for the benefit of, the Certificate Insurer [FGIC] as if the same were set forth in full herein.[9]

The Insurance Agreement defines "Operative Documents" to include the R&W Agreement. FGIC is an express third-party beneficiary of the R&W Agreement,[10] as well as of the other Operative Documents, a status that the Insurance Agreement confirms.[11]

91. Morgan Stanley's Loan Warranties include, among others, the following representations made as to each of the Mortgage Loans:

> (a) Mortgage Loans as Described. The information set forth in the Mortgage Loan Schedule relating to the Mortgage Loans is complete, true and correct as of the Cut-off Date.

---

[9] *See also* Insurance Agreement § 2.02(k). The other contracts included in the definition of "Operative Documents" are the Insurance Agreement itself, the Pooling and Servicing Agreement, the Certificates, and the Indemnification Agreement.

[10] Representations and Warranties Agreement § 11.

[11] Insurance Agreement § 2.02(k).

(b) Payments Current. Except with respect to the Mortgage Loans identified on Exhibit I-A, (i) all payments required to be made up to the Closing Date for the Mortgage Loan under the terms of the Mortgage Note, other than payments not yet 30 days Delinquent, have been made and credited, (ii) no payment required under the Mortgage Loan has been 30 days or more Delinquent at any time since the origination of the Mortgage Loan, and (iii) the first Monthly Payment was made with respect to the Mortgage Loan on its related Due Date or within the grace period, all in accordance with the terms of the related Mortgage Note.

(e) Compliance with Applicable Laws. Any and all requirements of any federal, state or local law . . . have been complied with . . . .

(g) Validity of Mortgage Documents. . . . No fraud, error, omission, misrepresentation, negligence or similar occurrence with respect to a Mortgage Loan has taken place on the part of the Sponsor, or, to the knowledge of the Sponsor, any other person, including without limitation, the related Mortgagor, any appraiser, any builder or developer, or any other party involved in the origination of the Mortgage Loan.

(i) No Defaults. . . . there is no default, breach, violation or event which would permit acceleration existing under the Mortgage or the Mortgage Note . . . .

(o) Predatory Lending Regulations. No Mortgage Loan is a High Cost Loan or Covered Loan, as applicable . . . . No Mortgage Loan is covered by the Home Ownership and Equity Protection Act of 1994 and no Mortgage Loan is in violation of any comparable state or local law.

(u) Appraisal. The Mortgage File contains an appraisal of the related Mortgaged Property . . . by a qualified appraiser, duly appointed by the mortgagee, who had no interest, direct or indirect in the Mortgaged Property or in any loan made on the security thereof, and whose compensation is not affected by the approval or disapproval of the Mortgage Loan, and the appraisal and appraiser both satisfy the requirements of Fannie Mae or Freddie Mac and Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 . . . .

(v) LTV. No Mortgage Loan has an LTV greater than 100%.

(w) The acquisition of the Mortgage Loans that were subject to the Master Repurchase Agreement, dated as of December 12, 2005 . . .

> was consummated in compliance with the Stipulation and Order dated April 27, 2007.

92. Morgan Stanley's warranty regarding the validity of the mortgage documents, promising the absence of "fraud, error, omission, misrepresentation, negligence or similar occurrence" in connection with the Mortgage Loans, was both unusual and specifically negotiated. Although Morgan Stanley did not make the Mortgage Loans directly, it funded and retained a security interest in the Mortgage Loans as a warehouse lender to New Century. Thus, FGIC demanded and received a warranty that Morgan Stanley itself did not commit any "fraud, error, omission, misrepresentation, negligence or similar occurrence" with respect to any Mortgage Loan. But this warranty did not end there. Morgan Stanley also represented that, to its knowledge, ***no one else*** had committed any "fraud, error, omission, misrepresentation, negligence or similar occurrence" with respect to any Mortgage Loan. Given Morgan Stanley's intimate knowledge of the Mortgage Loans, resulting from its secured warehouse facility and the extensive loan-level diligence that it performed, Morgan Stanley had actual and/or constructive knowledge of any "fraud, error, omission, misrepresentation, negligence or similar occurrence" with respect to the Mortgage Loans, particularly to the extent that these occurrences were systematic.

93. Morgan Stanley made certain additional Loan Warranties with respect to each of the "Group I Mortgage Loans," which were a subset of the Mortgage Loans that were to comply with guidelines allowing them to be purchased by certain federal agencies. These additional representations and warranties include:

> (c) Underwriting Methodology. The methodology used in underwriting the extension of credit . . . does not rely on the extent of the related Mortgagor's equity in the collateral as the principal determining factor in approving such extension of credit. The methodology employed related objective criteria that related such facts as, without limitation, the related Mortgagor's income, assets, and liabilities to the proposed mortgage payment and, based on such methodology, the Group I Mortgage Loan's originator made a

reasonable determination that at the time of origination the related Mortgagor had the ability to make timely payments on the Group I Mortgage Loan.

(e) Freddie Mac Loan Limits. The original principal balance of each Group I Mortgage Loan was within Freddie Mac's dollar amount limits for conforming one- to four-family mortgage loans and the original principal balance for each Group I Mortgage Loan which is a Second-Lien Mortgage Loan was within one-half of Freddie Mac's dollar amount limits for one-unit conforming one-to four-family mortgage loans for first-lien mortgage loans, without regard to the number of units in the related Mortgaged Property.

(f) Freddie Mac Loan Limits for Second-Lien Mortgage Loans. With respect to each Group I Mortgage Loan which is a Second-Lien Mortgage Loan (A) such lien is on a one-to four-family residence that is the principal residence of the related Mortgagor, and (B) the original principal balance of the related First-Lien Mortgage Loan plus the original principal balance of any subordinate lien mortgage loans relating to the same Mortgaged Property was within Freddie Mac's dollar amount limits for First-Lien Mortgage Loans for that property type.

(i) Points and Fees. With respect to each Group I Mortgage Loan secured by the related Mortgagor's primary residence, no Mortgagor was charged "points and fees" in an amount greater than (i) $1,000, or (ii) 5% of the principal amount of such Group I Mortgage Loan, whichever is greater.

94. Under Section 4(a) of the R&W Agreement, a breach of the Loan Warranties obligates Morgan Stanley to "repurchase" the related Mortgage Loan within 60 days after it discovers or receives notice of the breach.[12] As set forth below, FGIC provided express notice of hundreds of breaches of the Loan Warranties based on its review of a sample of the Mortgage Loans. Additionally, Morgan Stanley independently discovered breaches of the Loan Warranties based on its review of the loans during diligence and through the daily contact of its affiliate,

[12] For the sake of completeness, FGIC notes that the R&W Agreement also contemplates the possibility that Morgan Stanley might "cure" a breach, or replace a breaching Mortgage Loan with one that is not in breach. The time allotted for such cure or replacement has long since expired, however, so those provisions are not relevant to this Complaint.

Saxon, with the borrowers and the loan files. However, despite these representations and warranties, Morgan Stanley failed to follow the repurchase protocol as specified in the operative documents, to the detriment of the Trust and ultimately FGIC as certificate insurer.

IV. FGIC Discovers Pervasive Breaches of the Loan Warranties and Breaches of the Transaction Warranties

95. Concerned with mounting losses on the Transaction, FGIC retained third-party consultants to review a sample of approximately 800 non-performing Mortgage Loans that had resulted in a loss to the Trust, in order to determine whether these loans complied with Morgan Stanley's Loan Warranties and whether New Century's loan origination practices were consistent with Morgan Stanley's Transaction Warranties. Remarkably, FGIC identified defects in every non-performing loan reviewed within this sample, with an aggregate principal balance of approximately $167 million.

96. For at least 300 loans in the sample, the related appraisals either did not comply with guidelines, or were not included in the loan files at all, in breach of the "Appraisal" Loan Warranty.

97. In breach of the Loan Warranty representing that, to Morgan Stanley's knowledge, there had been no "fraud, error, omission, misrepresentation, negligence or similar occurrence" on the part of any party, numerous loan files contained conspicuous evidence of fraud, which would have been apparent to Morgan Stanley, primarily involving misrepresentation of the borrower's income, assets, other liabilities, or intent to occupy the property as the borrower's residence (rather than as an investment). Morgan Stanley had actual and/or constructive knowledge of this conspicuous fraud and of New Century's error and negligence in allowing it to occur, based on Morgan Stanley's extensive knowledge of the Mortgage Loans and

the processes through which they were originated, as well as its own diligence in reviewing the Mortgage Loans.

98. In addition, FGIC also discovered that 231 loans had been 30 days delinquent at the closing of the Transaction, in breach of the "Payments Current" Loan Warranty. This was necessarily known to Saxon, and thus to its affiliate Morgan Stanley, at the time of the closing.

99. In breach of the "Compliance with Applicable Laws" Loan Warranty, the Transaction included Mortgage Loans violating a four-part test established to determine whether loans are presumptively "unfair" to borrowers, in violation of Massachusetts law. For example Loan ID [REDACTED] and Loan ID [REDACTED] made to Massachusetts borrowers, met this four-part test because each loan: (1) was an ARM loan with an introductory rate period of three years or less; (2) featured an introductory rate that was at least 3% below the fully-indexed rate; (3) was made to a borrower for whom the debt-to-income ratio would have exceeded 50% when calculated using the fully-indexed rate; and (4) exceeded a 100% loan-to-value ratio, featured a substantial prepayment penalty, or included a prepayment penalty extending beyond the introductory rate period.

100. In violation of the Transaction Warranties, the Mortgage Loans also contained pervasive violations of underwriting guidelines, including (i) a systemic failure to conduct the required income-reasonableness analysis for stated-income loans, resulting in the rampant origination of loans to borrowers who made unreasonable claims as to their incomes; and (ii) lending to borrowers with debt-to-income ratio ("DTI"), LTV, and CLTV ratios above the allowed maximums, after taking into account any compensating factors. These practices amounted to a wholesale abandonment of the underwriting and appraisal guidelines that were represented to be in place.

101. Several examples of the numerous material breaches and underwriting violations uncovered by FGIC are listed below:

- Loan Number [redacted] The borrower stated on his loan application that he was a production worker for an auto company in Troy, Michigan with an annual income of $126,000. New Century guidelines require the underwriter to compare the applicant's occupation and income to similar occupations and incomes in the area to evaluate the reasonableness of the stated income. The Bureau of Labor Statistics (BLS) Metropolitan and Non-Metropolitan database, a widely accepted industry benchmark for reasonable salary levels based on geographic location, indicated that the 90th percentile income level for a Production Worker in Troy, Michigan, was only $59,740 annually in 2006. The lender nonetheless approved the loan, which was represented to have a DTI ratio of 46.43% on the Mortgage Loan Schedule. The borrower's actual income was only $60,365.66, and the actual DTI ratio was 101.66%. According to the Servicer's records, the borrower made only eleven payments on this loan.

- Loan Number [redacted] The borrower received a cash-out refinance by claiming annual income of $111,600 from a Project Manager position. The borrower's credit profile and verified assets did not support the stated monthly income. During servicing, the borrower's tax returns showed that he was actually employed as a Janitor with an annual income of $27,717.30. Morgan Stanley misrepresented the loan as a rate-and-term refinance on the data tape. The data tape also showed a DTI ratio of 49.15%, while the actual DTI ratio was 200.41%.

- Loan Number [redacted] The borrower claimed an annual income of $264,000 as the self-employed proprietor of an entertainment business. The lender was aware that the borrower actually had multiple business operations, and originally stipulated that the borrower was to provide a detailed letter of explanation of what she does for business. The lender waived this condition and approved the loan even though the LTV ratio also exceeded guidelines. Morgan Stanley misrepresented the loan's CLTV ratio (100%) on the data tape (80%). The data tape also reported a DTI ratio of 47.14%. The actual DTI ratio was 971.65%.

102. The number and nature of the defects identified by FGIC's review of a sample of the Mortgage Loans make clear that the Mortgage Loans as a whole were systematically originated with virtually no regard for the borrowers' ability or willingness to repay their obligations (the fundamental precept of mortgage lending). Borrowers were permitted or encouraged to take out loans they obviously could not afford.

103. New Century's wholesale abandonment of its underwriting guidelines and breaches of the Loan Warranties materially and adversely affected FGIC's interest in both individual Mortgage Loans and in the Transaction as a whole. Loans that are not appropriately originated and underwritten, or with key attributes otherwise misrepresented, are markedly more risky and therefore less valuable than loans not suffering from such deficiencies. Morgan Stanley's inclusion of such loans among the Mortgage Loans therefore materially increased FGIC's risk of loss from issuing its Policy and impaired the collateral value of the Mortgage Loans.

104. Additionally, FGIC's review demonstrates the falsity of Morgan Stanley's representations concerning its own operations, including its asserted practice to perform appropriate due diligence procedures before acquiring residential mortgage loans for securitization.

105. Taken together, the breaches of warranties described above reveal the falsity and misleading nature of the various statements and other information provided by Morgan Stanley to FGIC regarding, among other things, the Mortgage Loans in aggregate and the practices pursuant to which they were purportedly originated and screened for inclusion in the Transaction, as well as Morgan Stanley's operations to review mortgage loan sellers such as New Century before acquiring loans for securitization. Accordingly, the defects found through this review establish breaches of Morgan Stanley's Transaction Warranties.

V. MORGAN STANLEY FRUSTRATES THE REPURCHASE PROTOCOL BY REPURCHASING ONLY A HANDFUL OF LOANS

106. From 2011 to the present, FGIC has identified approximately 800 Mortgage Loans that are in breach of the Loan Warranties and demanded their repurchase.

107. Over this same period, Morgan Stanley has repurchased only 6 of these Mortgage Loans. Morgan Stanley failed to provide any legitimate basis for refusing to repurchase the remaining breaching loans.

VI. Repurchase Demands Made by the Trustee Corroborate FGIC's Findings of Breach

108. On December 20, 2012, Federal Home Loan Mortgage Corporation ("Freddie Mac"), as an owner of certain certificates issued by the Trust, provided notice of breach of the Loan Warranties for 199 Mortgage Loans included in the Transaction. The original principal balance of these loans was $43,556,094. The Trustee, in turn, demanded that Morgan Stanley repurchase the breaching loans.

109. On February 1, 2013, Freddie Mac provided notice of breach of the Loan Warranties for 242 additional Mortgage Loans included in the Transaction. The original principal balance of these loans was $43,142,436. The Trustee, in turn, demanded that Morgan Stanley repurchase the breaching loans.

110. Freddie Mac's findings of hundreds of breaching Mortgage Loans corroborate FGIC's findings that the Transaction involved pervasive breach of the Loan Warranties, as well as breach of the Transaction Warranties. Morgan Stanley's SEC filings state that repurchase has been requested for 1,214 Mortgage Loans in the Transaction having an aggregate principal balance of $241 million.

111. To FGIC's knowledge, Morgan Stanley has not repurchased any of the Mortgage Loans identified in the two notice letters sent by the Trustee to date.

VII. An Order Entered by the SEC Corroborates FGIC's Findings of Breach of the Transaction Warranties

112. On July 24, 2014, the SEC instituted cease-and-desist proceedings against Morgan Stanley based on the Transaction at issue here and another RMBS deal that closed in

2007. As part of a settlement, Morgan Stanley consented to the entry of an order making certain findings against it. Morgan Stanley did not deny these findings, which provide the basis for the SEC's continuing cease-and-desist order against Morgan Stanley.

113. In particular, the SEC found that the ProSupp for the Transaction materially understated the level of current delinquencies in the Mortgage Pool. As a consequence of the particular materially misleading statement identified by the SEC, Morgan Stanley agreed to disgorgement in excess of $21 million.

114. The SEC's findings corroborate FGIC's findings that Morgan Stanley breached its Transactions Warranties, including its warranty that the Offering Documents "do not contain any untrue statement of a material fact and do 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." Morgan Stanley should be required to pay for the harm resulting from its additional false and misleading statements in the ProSupp and additional breaches of the Transaction Warranties.

VIII. SAXON AND MSAC BREACHED THE PSA AND A RELATED SIDE LETTER AGREEMENT

115. In its role as Servicer for the Transaction, Saxon[13] repeatedly breached its obligations under the PSA (and a Side Letter Agreement entered with respect to the PSA) to

[13] Saxon employed Ocwen Loan Servicing LLC ("Ocwen") as subservicer, commencing in 2009, and continuing through April 2, 2012. Saxon, as the Servicer, was permitted to employ subservicers, but Saxon was still responsible for the servicing of the Transaction, and liable both for its own acts and omissions as Servicer and for the acts and omissions of any subservicer. Section 3.01(d) of the PSA provides that while the Servicer may delegate its responsibilities under the PSA, "no such delegation shall release the Servicer from the responsibilities or liabilities arising under this Agreement." Additionally, Section 3.04 provides that notwithstanding any subservicing agreement, "the Servicer shall remain obligated and primarily liable to the Trustee for the servicing and administering of the Mortgage Loan in accordance with the provisions of Section 3.01 without diminution of such obligation or liability by virtue of such Subservicing Agreements . . . and to the same extent and under the same terms and

benefit itself and Morgan Stanley, at the expense and to the detriment of the Trust and FGIC. First, Saxon failed to provide the required notice to Transaction participants when it discovered breaches of the Loan Warranties made by Morgan Stanley. By concealing these breaches, Saxon allowed Morgan Stanley to circumvent and frustrate its obligations to repurchase the breaching Mortgage Loans. Second, Saxon failed to service the Mortgage Loans in accordance with the PSA, breaching its duty to mitigate losses to the Trust and FGIC, while deriving improper servicing fees and other revenue. Saxon's servicing deficiencies were egregious, constituting willful misfeasance, bad faith, negligence and/or a reckless disregard for its obligations under the PSA. Finally, Saxon breached warranties that it made to FGIC in the PSA relating to its operations and the Mortgage Loans, which it had been servicing well before the closing of the Transaction.[14] Had FGIC known of Saxon's breaches, it never would have entered into the Transaction.

A. Saxon Failed to Provide Notice of Breaches of the Loan Warranties

116. As Servicer for the Transaction, Saxon had daily contact with borrowers and daily access to the loan files. Moreover, Saxon effectuated hundreds of modifications of delinquent Mortgage Loans in the Transaction. Loan modifications generally require a review of the related loan origination file to assess the borrower's ability to repay.[15] This extensive and systematic

---

conditions ***as if the Servicer alone were servicing and administering such Mortgage Loans***" (emphasis added). Accordingly, Saxon was responsible for and liable for the acts and omissions of Ocwen, as subservicer, during such period. References herein to the servicing activities and servicing records of "Saxon" include the activities of Ocwen, as subservicer.

[14] The same servicing records demonstrating Saxon's breaches of the PSA also show that MSAC (the Depositor) breached the warranty of good title to the Mortgage Loans that it made to FGIC in the PSA. *Infra.* These breaches materially and adversely affected the value of the Mortgage Loans and FGIC's interest therein, and MSAC was and is obligated to purchase from the Trust the breaching Mortgage Loans as a result.

[15] As described below, FGIC's review of Saxon's practices revealed that Saxon did not conduct the type of analysis that it should have when it received modification requests from performing

access to information about the Mortgage Loans provided Saxon with actual or constructive knowledge of the facts relevant to the Loan Warranties, and therefore placed Saxon in a position to identify breaches of the Loan Warranties.

117. Under Section 2.07 of the PSA, Saxon had a contractual obligation to provide notice of any breach of a representation or warranty made by MSMC in the R&W Agreement promptly upon discovery of such breach. Section 2.07 states, "the party discovering such breach shall give prompt written notice thereof to the other parties to this Agreement and the Sponsor."

118. This clear obligation to provide notice of breaches of the Loan Warranties was a material consideration in FGIC's decision to participate in the Transaction. Saxon's commitment assured FGIC that Saxon would notify the other parties of breaches of the Loan Warranties it discovered, without prompting or oversight and without regard to the fact that the party responsible for repurchasing breaching loans was its corporate affiliate.

119. The pervasive breaches of the Loan Warranties identified by both FGIC and Freddie Mac demonstrate that, given Saxon's close, daily contact with borrowers and the loan files, Saxon had actual, constructive and/or inquiry notice of numerous breaches of the Loan Warranties both before and after closing of the Transaction, as defaults mounted.

120. Indeed, a spreadsheet prepared by Saxon approximately six months after closing of the Transaction reveals that Saxon had documented evidence of actual or potential breaches of the Loan Warranties. In the spreadsheet, Saxon noted its conclusion as to the cause for the default of a large number of the Mortgage Loans in the short period after the Transaction closed. For 305 of those Mortgage Loans, Saxon concluded that the default was caused by "Excessive

---

borrowers. But Saxon's failure to conduct proper diligence in those circumstances does not allow Saxon to claim ignorance of the loan origination files.

Obligation," *i.e.*, that the Mortgage Loan was more than the borrower could possibly afford.[16] Saxon's discovery that the borrowers did not at that time have a reasonable ability to repay their Mortgage Loans was evidence of an actual or potential failure to comply with fundamental underwriting and origination standards, and associated material misstatements in the Mortgage Loan Schedule, which provided various metrics of each borrower's ability to pay the loan in question. Thus, Saxon had actual, constructive or inquiry notice of actual or potential breaches of the Loan Warranties.

121. Saxon also had notice of mortgaged properties that were incorrectly represented to be owner-occupied. For 30 of the Mortgage Loans included in the spreadsheet, which the Mortgage Loan Schedule specified were made to acquire (and secured by) the borrower's primary residence, Saxon concluded that the reason for default was "Inability to rent property" or "Tenant not paying." (In addition, a separate review of other Mortgage Loans conducted by FGIC showed that many borrowers had requested a "change of address for billing," indicating the subject properties were not, in fact, their primary residences.) Saxon thus had actual, constructive or inquiry notice that these borrowers were not using the mortgaged property as their primary residences, as had been represented in the Mortgage Loan Schedule.

122. Finally, for 3 of the loans in the spreadsheet, Saxon indicated that the reason for default was "Fraud." These facts also provide evidence that Saxon knew, or knew facts that enabled it to conclude, that such Mortgage Loans were in breach of the Loan Warranties.

123. Saxon continued to monitor defaults and to determine the reasons for such defaults in the same fashion in 2008 and beyond, as defaults began to mount. Saxon thus continued to discover breaches of the Loan Warranties throughout its tenure as Servicer.

---

[16] Other causes for defaults noted by Saxon included "Curtailment of Income," "Borrower Illness," "Inability to Rent Property" and "Tenant not paying."

124. Saxon had first-hand knowledge of these facts, and was obligated to provide notice of the breaches it discovered. But Saxon never provided notice of breach of the Loan Warranties with respect to the Mortgage Loans described above. Indeed, Saxon never provided ***any*** notice of ***any*** breaches of the Loan Warranties while it was the Servicer.

125. By concealing and failing to provide the requisite notice of the pervasive breaches of the Loan Warranties, Saxon supported its Morgan Stanley affiliates' avoidance (if not outright repudiation) of their massive obligations to repurchase breaching Mortgage Loans, and thereby supported their avoidance of those obligations. Saxon's failure to provide notice of breaches of the Loan Warranties promptly upon discovery thereof breached its obligations under Section 2.07 of the PSA.

B. Saxon Repeatedly and Systematically Failed to Comply with its Servicing Obligations under the PSA

126. Section 3.01(a) of the PSA required Saxon to service the Mortgage Loans in a manner that maximized recoveries for the benefit of the Trust and FGIC. As described in greater detail below, Saxon wholly failed to comply with such obligations. Instead, Saxon's servicing practices placed its own interest (and that of its affiliates) ahead of, and to the detriment of, the Trust's and FGIC's interests. As a result, Saxon engaged in willful misfeasance, bad faith, negligence and/or reckless disregard of its contractual obligations under the PSA.

127. Section 3.01 of the PSA provides:

a. For and on behalf of the Certificateholders and for the benefit of the Certificate Insurer.....the Servicer shall seek to maximize the timely and complete recovery of principal and interest on the Mortgage Notes.

b. The Servicer shall service and administer the Mortgage Loans in accordance with applicable state and federal law.

128. Concerned with mounting losses in the Transaction, beginning in 2008, FGIC has at various times reviewed the records and practices of Saxon and the subservicer that it engaged.

Based on these reviews of servicing records and discussions with personnel employed by Saxon and its subservicer, FGIC has learned of certain deficiencies in Saxon's servicing practices, which are described below. These are illustrative examples only, and are not a complete statement of all the ways in which Saxon breached its servicing obligations.

1. Failure to Mitigate Losses

129. In order to comply with its obligations under, *inter alia*, Section 3.01(a) of the PSA, Saxon was required to engage in prudent loss mitigation practices with respect to delinquent borrowers. Saxon failed to do so.

130. In 2008, FGIC retained a consultant to review Saxon's servicing in the Transaction. As part of this review, FGIC's consultant reviewed Saxon's servicing records for a sample of loans. This review revealed Saxon's failure to engage in proper loss mitigation with respect to approximately 35% of the Mortgage Loans in the sample.

131. For example, Loan #[redacted] was an active foreclosure at the time of the consultants' review. Findings indicate that a foreclosure sale was postponed due to a short sale offer of $520,000 submitted on November 26 by an authorized agent of the debtor. Saxon failed to respond to repeated inquiries from the agent, however, and then inexplicably declined the offer on January 19, 2009 due to "non-responsiveness" from the debtor, even though the debtor was represented by an authorized agent. The foreclosure sale date was then set for April 2009, but then foreclosures were suspended, and the loan stayed in foreclosure for four years until it was modified in 2012. At that point in time it had accrued in excess of $200,000 in delinquent interest and resulted in a loss of $378,000 to the Trust, due to forgiveness of debt, on an active balance of $498,000. The entire loss could have been avoided, however, if the short sale offer had been accepted and the property sold.

132. The following examples provide further evidence of Saxon's failings:

> With regard to Loan [redacted], Saxon failed to accept a short sale offer, despite the fact that the value to the Trust would have been greater than that being offered at foreclosure. Instead, Saxon responded with an unrealistic counteroffer. As a result, the property went into foreclosure. Despite the fact of the foreclosure, Saxon made no attempt to evict the tenants.
>
> With regard to Loan # [redacted] Saxon approved a loan modification, but failed to send the necessary paperwork to the borrower for over three months. Although the borrower agreed to make payments under the modification, upon submitting the initial payment the borrower was told that the original offer had expired. Saxon then offered another modification to the borrower, at terms that were less favorable to the Trust.
>
> With regard to Loan [redacted], Saxon failed to respond to a proposed workout package for at least 53 days, despite repeated calls from the borrower. Similarly, with regard to Loan [redacted], Saxon failed to respond to a proposed modification for at least 80 days, despite repeated contacts from the borrower. And with regard to Loan [redacted], Saxon failed to respond to a proposed modification for at least 87 days, despite repeated contacts from the borrower.
>
> And, with regard to Loan # [redacted], Saxon had made no attempt to contact the borrower to implement any form of loss mitigation at all, despite the fact that the loan had been delinquent for over six months.

133. FGIC thereafter obtained copies of the servicing notes for the Mortgage Loans covering a period from early 2007 through the end of Saxon's tenure as the Servicer. These servicing notes show Saxon's servicing activities through April 2, 2012. While it was Servicer, Saxon repeatedly failed to act promptly and responsibly to mitigate losses from borrower defaults.

134. For example, Loan [redacted] had its foreclosure referral placed on hold due to a modification review pursuant to a modification package received on December 8, 2008. This loan was eventually liquidated in 2010, accruing in excess of $60,000 in delinquent interest, and resulting in a $214,000 loss to the Trust.

135. These and other failures to adequately mitigate losses breached Saxon's obligations under the PSA and harmed FGIC by increasing losses incurred by the Insured Certificates.

2. Delays in Foreclosures

136. Saxon's tenure as Servicer was marked by inexcusable delays in the foreclosure process. Timely foreclosure is required to maximize the recovery on the property and minimize the associated foreclosure and servicing costs. The Trust is harmed by each month that passes in which the Trust receives no payments, the property remains in the hands of a delinquent borrower having little incentive to maintain it, and the Trust continues to pay servicing fees for an asset that is generating no revenue. Saxon's performance as a servicer was woefully deficient, and in breach of the PSA.

137. As Servicer, Saxon controlled how quickly foreclosure proceedings were commenced following the receipt of the last payment from a borrower. For first liens, once a loan is 90 days delinquent, a prudent servicer typically would initiate foreclosure. Based on a review of over 2,000 foreclosed loans, the average time from when Saxon received the last paid installment to when a foreclosure was initiated was in excess of 160 days.

138. FGIC's review of servicing records also revealed that Saxon fell far short of complying with foreclosure time lines established by Freddie Mac on a state-by-state basis. These guidelines represent the longest time that should elapse between the due date of the last payment and the foreclosure sale. In all but a handful of states, Saxon's foreclosure time lines exceeded the Freddie Mac guidelines. Indeed, in 14 states, Saxon's ***average*** foreclosure time line exceeded the Freddie Mac guidelines by more than 10 percent. These delays evidence a systemic failure that was the product of a reckless disregard of Saxon's obligations under the PSA.

139. In many cases, delays in the foreclosure process resulted from Saxon's improper practices that have been publicly identified and condemned by governmental authorities. Saxon's improper servicing practices were described in a Consent Order with the Federal Reserve entered by Morgan Stanley, on Saxon's behalf, as of April 2, 2012 – a date that coincided with Saxon's transfer of servicing responsibilities for the Transaction through sale of its servicing platform to Ocwen. These practices, which were characterized as "unsafe or unsound banking practices," included: (a) filing in state and federal courts numerous affidavits in which the affiant falsely represented that certain matters were based on the affiant's personal knowledge or review of records; (b) filing improperly signed or notarized affidavits; (c) litigating in foreclosure and bankruptcy proceedings without confirming that documentation of ownership (such as promissory notes and mortgage documents) was in order; (d) failing to provide appropriate resources and staffing to handle the foreclosure process and loss mitigation activities; and (e) failing to have adequate controls, policies and procedures, compliance risk management, internal audit, training and oversight of the foreclosure process.

140. These unsafe practices and violations of law by Saxon increased the cost of foreclosures and extended the time during which severely delinquent loans remained in the Trust. Needless foreclosure costs were a financial drain on the Trust. Delays in the foreclosure process, often caused by Saxon's failure to comply with applicable law, also extended the time during which Saxon could charge servicing fees for Mortgage Loans that were highly unlikely ever to be repaid. These additional expenses – caused by Saxon's willful misfeasance – diminished the funds available to pay certificateholders and increased FGIC's exposure under its Policy.

3. Modification of Loans Not in Default

141. The Trustee reports and admissions by Ocwen regarding its servicing practices on behalf of Saxon with respect to the Transaction revealed that Saxon repeatedly engaged in

improper modifications of loans that were not in default. Indeed, while Saxon was Servicer, at least one hundred performing loans were modified without the requisite inquiry into the borrowers' ability to repay the existing obligations. These modifications typically involved the extension of amortization terms, the forgiveness of principal and/or reductions in accrued interest and, therefore, reduced the cash flow into the Trust and increased FGIC's exposure under its Policy.

142. Saxon was motivated by the financial incentives offered by the federal government to make loan modifications under the Treasury Department's HAMP (Home Affordable Modification Program), and thus made loan modifications negligently and with reckless disregard for whether such modifications were in the Trust's or FGIC's interest. Indeed, it is telling that Saxon aggressively modified a large number of fully performing loans, while at the same time disregarded its obligation to engage in proactive loss mitigation efforts or to initiate foreclosure for many hundreds of severely delinquent loans.

143. When it engaged Ocwen as a subservicer, Saxon ensured that Ocwen would focus on obtaining loan modification payments under HAMP because such payments constituted a major portion of Ocwen's compensation. At the same time, Ocwen received a less-than-standard fee, expressed as a percentage of the outstanding principal amount of the loans. Thus, Saxon gave Ocwen a strong incentive to modify loans without regard to the necessity for such modifications, and little incentive to service the Mortgage Loans in more traditional ways.

144. Section 3.01(c) of the PSA expressly prohibited Saxon from modifying performing loans except under certain limited circumstances. Saxon could do so only if, "in the judgment of the Servicer, a default is reasonably foreseeable, and only to the extent the Servicer determines that such action is not materially adverse to the interests of the Certificateholders and

the Certificate Insurer (taking into account any estimated Realized Loss that might result absent such action)."

145. This provision required Saxon to conduct analysis and to exercise independent judgment in two respects. First, the Servicer must make a "judgment" that default is "reasonably foreseeable." Second, the Servicer must "determine[]" that a modification is not materially adverse to FGIC's interests, after making an estimate of any Realized Loss to the trust from failing to modify the loan.

146. In response to FGIC's inquiries in late 2012 and early 2013, Ocwen effectively conceded that, during the time it was the subservicer for Saxon, Ocwen (and therefore Saxon) did not comply with either obligation under Section 3.01(c). Instead of conducting a reasoned analysis and exercising independent judgment to determine whether the modification of a performing loan was in FGIC's interest, Ocwen (and therefore Saxon) simply granted requests for modification whenever performing borrowers asserted that they would stop making payments in the absence of a modification. By its own admission, Ocwen (and therefore Saxon) made no attempt to verify what it was being told by these borrowers, to confirm that borrowers had the means to make either the current or the modified payments, or to ask for the type of documentation that a prudent servicer would require in determining how to respond to a request to modify a performing loan. Ocwen (and therefore Saxon) simply acceded to these unsupported modification requests and collected loan modification payments from the federal government.

147. In short, Ocwen repeatedly took the path that brought it the greatest remuneration with the least effort, to the detriment of the Trust and FGIC. Without conducting any diligence or verification, Ocwen (and therefore Saxon) caused the Trust to accept less advantageous terms from borrowers, pocketing HAMP payments from the federal government for doing so. This

practice was no mere lapse in judgment, but instead represented Ocwen's (and therefore Saxon's) deliberate subjugation of FGIC's interest to its own self-interest. As such, Ocwen (and therefore Saxon) engaged in willful misfeasance, bad faith, negligence and/or reckless disregard of its obligations under the PSA.

4. Extension of Mortgage Loan Maturity Dates Beyond the Maturity Date of the Certificates

148. Saxon repeatedly agreed to extend the dates for loan maturities and balloon payments beyond the May 2037 maturity date for the Certificates. This practice had the effect of reducing principal and interest payments on the Mortgage Loans to the Certificateholders, thus increasing the claims against FGIC's Policy at the maturity of the Certificates.

149. The Certificates will mature on the Distribution Date in May 2037, at which point, FGIC will have an obligation to make up certain shortfalls in principal and interest payments to Insured Certificateholders.

150. On average, Saxon extended the loan maturities on the affected loans ten years past their original final maturity dates. The affected loans comprise approximately $20 million in aggregate principal amount.

151. This practice exposed FGIC without its consent to tens of millions of dollars in liability for risks that could have and should have been mitigated through the proper administration of the PSA.

5. Thwarted On-Site Visits

152. Finally, Saxon thwarted FGIC's efforts to learn of its misconduct by refusing to allow FGIC's outside consultant to conduct an on-site inspection of Saxon's records and operations.

153. Section 12.09 of the PSA gives FGIC broad rights to inspect and audit Saxon's servicing of the Mortgage Loans. More specifically, on five business days' notice, the Servicer must permit "***any representative***" of FGIC to examine "all the books of account, records, reports and other papers" of the Servicer relating to the Mortgage Loans. Additionally, the Servicer must allow FGIC's representative "to discuss its affairs, finances and accounts relating to the Mortgage Loans with its officers, employees and independent accountants."

154. FGIC attempted to avail itself of these broad rights by retaining a consultant having specialized servicing expertise to conduct an on-site review of Saxon's servicing in April 2012. In response to this routine request – plainly authorized by the PSA – Saxon insisted that FGIC deal with its outside litigation counsel at Davis Polk & Wardwell LLP. Saxon's litigation counsel refused to allow FGIC's consultant to conduct an on-site review, insisting that only FGIC employees could participate.

155. Saxon's refusal to allow FGIC's outside consultant, a "representative" of FGIC within the meaning of Section 12.09 of the PSA, to review Saxon's records and operations was entirely without basis and represented a bad faith refusal to provide FGIC information and access to which it was expressly entitled. Saxon's willful misfeasance had the effect of concealing Saxon's prior misconduct.

6. Saxon Breached the Side Letter Agreement to the PSA

156. In 2009, Saxon approached FGIC for its consent in hiring Ocwen to act as subservicer for a defined subset of the Mortgage Loans that were in the pool at that time. FGIC and Saxon then entered into a Side Letter Agreement that required (a) notice to FGIC whenever new loans were referred to Ocwen for subservicing, and (b) FGIC's consent in the event that Saxon transferred its servicing obligations to Ocwen.

157. Although additional loans were referred to Ocwen for subservicing, Saxon never notified FGIC of these developments, which deprived FGIC of the opportunity to monitor Ocwen's activities to ensure that they complied with the requirements of the PSA.

158. Moreover, Saxon transferred its servicing obligations to Ocwen in April 2012 without requesting or receiving FGIC's consent. By proceeding in this fashion, Saxon denied FGIC the opportunity to demand, as a condition to FGIC's consent to the servicing transfer, certain assurances concerning how the Mortgage Loans had been serviced to date (with Ocwen acting as Saxon's subservicer), and concerning how the Mortgage Loans would be serviced going forward (with Ocwen substituting for Saxon as the servicer).

159. Saxon's disregard of its obligation to obtain FGIC's consent to a servicing transfer occurred at the same time that Saxon's stonewalling prevented FGIC from sending an expert consultant to review its servicing records. Taken together, these two breaches by Saxon prevented FGIC from learning of Saxon's failure to adhere to the requirements of the PSA in servicing the Mortgage Loans. Only later, after Saxon had resigned as service for the Transaction, did FGIC identify many of the substantive servicing breaches described above.

160. As a result of the foregoing, Saxon breached its obligations to FGIC under the Side Letter Agreement.

C. Saxon and MSAC Breached the Warranties They Made in the PSA

161. In addition to revealing the breaches of Saxon's servicing obligations described above, Saxon's servicing records establish that both Saxon and MSAC (the Depositor) breached the representations and warranties that they provided to FGIC in the PSA. Saxon further breached its obligations by failing to notify FGIC of these breaches, as it was required to do under the PSA.

1. Breaches of Saxon's Warranties Made in the PSA

162. In Section 2.03(a) of the PSA, Saxon made certain representations to FGIC, which were set forth in Schedules II and II-A of the PSA. These warranties include:

> (g) The Servicer represents that its computer and other systems used in the servicing of the Mortgage Loans operate in a manner such that the Servicer can service the Mortgage Loans in accordance with the terms of this Pooling and Servicing Agreement;
>
> (l) No Defaults. With respect to each Mortgage Loan, to the best knowledge of the Servicer, other than payments due but not yet 30 days Delinquent, there is no material default, breach, violation or event which would permit acceleration existing under the Mortgage or the Mortgage Note;

163. Saxon's servicing records show that its warranty regarding the nature of its "computer and other systems" was false. While Saxon's computer systems actually recorded evidence of breach of the Loan Warranties, they did not operate in a manner to provide notice of breaches of the Loan Warranties in accordance with Saxon's servicing obligations under Section 2.07 of the PSA. More specifically, Saxon's computer and other systems failed to provide a feedback mechanism to provide notice of breaches automatically to the other parties to the Transaction, or to prompt someone within Saxon to do so. This was a material deficiency in Saxon's computer systems that was never remedied during Saxon's tenure as Servicer.

164. Additionally, contrary to the warranty provided in subsection (l), numerous Mortgage Loans were in breach or default at closing. The following are just a few examples that FGIC identified in which Saxon's servicing records reflected evidence that Saxon had knowledge that the borrowers were in default of their representations that they had authority to enter into their mortgages and were entering into valid agreements, and in default of their obligations to occupy and maintain their properties:

> Loan No. [REDACTED]: Saxon's records show that it was advised on May 4, 2007 -- before the closing -- that the supposed borrower did not own the property in question. Saxon discussed issues the supposed borrower had experienced in connection with a stolen purse, the filing of a police report, and "step[s] to report fraud." Several months later (after the closing) Saxon changed the default code associated with this loan to

"fraud," apparently reflecting its determination that there had been fraud in the origination of this loan. No loan payments were ever made.

Loan No. [redacted]: Saxon's records show that it was aware no later than May 21, 2007 that the purported borrower had claimed to have been the victim of a fraud, that "she [was] going to file a police report," and that she "doesn't want anything to do with this loan." Prior to the closing, Saxon changed the default code associated with this loan to fraud, but it was nonetheless included in the Transaction.

Loan No. [redacted] Saxon's records show that, on April 27, 2007, it was informed by the borrower that he had never lived in the property, and that he was a victim of a fraud. However, the default code that Saxon chose to describe this loan was "payment dispute." Only eight months later, after the closing, was the default code changed to fraud. No explanation was given in Saxon's records for this belated change.

Loan No. [redacted] Saxon initiated foreclosure in July 2007, but could not proceed because the mortgage lien was not valid. The matter was apparently referred to Saxon's fraud department based on apparent fraud by the closing agent. No payment was ever made on this loan.

Loan No. [redacted]: Saxon classified the property as vacant on May 1, 2007. But Saxon took no action to mitigate any losses until October 2008. In the intervening seventeen months, the house became a center of drug related activity (resulting in intervention by federal agents) resulting in substantial losses.

165. These and similar breaches of Saxon's warranties made in the PSA harmed FGIC because they materially increased FGIC's risk of loss from agreeing to participate in the Transaction and to issue its Policy.

2. Breaches of MSAC's Warranties Made in the PSA

166. In Section 2.03(d) of the PSA, the Depositor (MSAC) made certain representations to FGIC, which were set forth in Schedule III of the PSA. More specifically, MSAC represented and warranted that, immediately prior to MSAC's transfer of the Mortgage Loans to the Trust on the Closing Date, MSAC "had good title to the Mortgage Loans, free and clear of any liens, charges, claims or encumbrances whatsoever."

167. This warranty was false for numerous Mortgage Loans. Saxon's servicing notes demonstrate that the Transaction included many Mortgage Loans for which MSAC lacked good title.

168. FGIC's review of servicing records identified other instances of deficiencies including, for example:

> Loan No. [redacted]: The title insurance company denied a claim made under its policy on the basis that the closing attorney fraudulently signed the title commitment. Saxon was unable to foreclose on this mortgage and no payment was ever made.

169. These and similar breaches of MSAC's warranties materially increased FGIC's risk of loss from agreeing to participate in the Transaction and to issue its Policy.

170. Under Sections 2.03(e) and (f) of the PSA, Saxon had an obligation to provide notice of any breach of MSAC's warranties upon discovery. Despite the fact that Saxon's servicing notes demonstrated Saxon's discovery of breaches of MSAC's warranty of good title to certain Mortgage Loans, Saxon failed to provide notice of these or any other breaches of MSAC's warranties under the PSA. This failure to provide notice of MSAC's breaches of its warranties constituted a further breach of the PSA by Saxon.

171. MSAC has an obligation to repurchase any Mortgage Loan breaching its warranty of good title within 60 days of either discovery or notice of any such breach that materially and adversely affects the value of any Mortgage Loan or the interest of FGIC or the Trustee in such Mortgage Loan. By its very nature, a defect in MSAC's title -- and thus to the Trust's title -- to a Mortgage Loan materially and adversely affects its value to the Trust and to FGIC. Without good title, the Trust cannot enforce its rights and remedies against the borrower.

172. Based on the diligence that Morgan Stanley said it conducted in connection with its financing and purchase of the Mortgage Loans, it stands to reason that MSAC discovered

defects in its title to numerous Mortgage Loans. MSAC nonetheless failed to provide notice of such defects, as it was required to do under the PSA. Morgan Stanley has not repurchased any loans based on title defects. And despite the numerous examples cited herein, Morgan Stanley has repurchased only six loans to date, a woefully inadequate number considering the high percentage of the Mortgage Loans examined that have been found to be in breach of the Loan Warranties, the warranty of good title, or both.

IX. MORGAN STANLEY DISCOVERED AND HAD ACTUAL, CONSTRUCTIVE AND/OR INQUIRY NOTICE OF POOL-WIDE LOAN WARRANTY BREACHES

173. As described above, both FGIC and Freddie Mac (through the Trustee) provided Morgan Stanley actual notice of breaches of the Loan Warranties based on samples of hundreds of Mortgage Loans. The breaches found in these samples signaled systematic deficiencies in the loan origination process at New Century that were unlikely to be limited to the particular loans included in these samples. Morgan Stanley's actual notice of the number and nature of these Loan Warranty breaches identified by FGIC and Freddie Mac placed Morgan Stanley on constructive and/or inquiry notice of similar breaches of the Loan Warranties throughout the entire Mortgage Pool.

174. Morgan Stanley represented that it conducted its own review of approximately 50 percent of the loans before the closing of the Transaction. It was also familiar with New Century's loan origination practices because of its role as a secured warehouse lender and its securitization of thousands of New Century loans in other deals before concluding the Transaction. Based on this extensive knowledge, Morgan Stanley likely discovered numerous breaches of the Loan Warranties at the time of the closing of the Transaction. The breaches that Morgan Stanley had discovered at or before the closing placed it on constructive and/or inquiry notice of similar breaches throughout the Mortgage Pool.

175. Both before and after closing, Saxon had daily contact with borrowers and daily access to the loan files. When a borrower defaulted or requested loan modification, which occurred quite frequently in this Transaction, it was typical for a servicer to review the loan origination file to confirm that the borrower's statements were consistent with the facts contained in the origination file. Additionally, as described in greater detail above, Saxon made entries in its servicing system that evidenced breaches of the Loan Warranties.

176. On information and belief, Morgan Stanley, both directly and through Saxon, continued to discover numerous breaches of the Loan Warranties after closing of the Transaction. Morgan Stanley's own discovery of breaches, combined with the damning information about New Century that became public after closing (which is described below), placed Morgan Stanley on constructive and/or inquiry notice of pervasive breaches of the Loan Warranties throughout the entire Mortgage Pool.

X. PUBLIC FILINGS FURTHER REVEAL THE IMPROPER MORTGAGE-LENDING AND SECURITIZATION PRACTICES OF NEW CENTURY AND CORROBORATE FGIC'S FINDINGS OF BREACH

177. FGIC's own findings about New Century's loan origination practices, based on the review of a sample of hundreds of loan files conducted by its consultants, are corroborated by evidence that came to light from public sources after the closing of the Transaction, including a report issued in New Century's bankruptcy case, the Congressional Financial Crisis Inquiry Commission, and a fraud suit filed in Part 3 of this Court by investors in the same Transaction at issue here. These sources confirm the deficiency of New Century's processes for originating mortgage loans, including its manipulation of property appraisals. The result was a system designed to maximize the number of loans New Century could securitize without regard to borrowers' ability to repay. The full extent of New Century's malfeasance was not generally-

known until after these sources became public, which occurred after the closing of the Transaction.

178. In New Century's bankruptcy proceeding, a Bankruptcy Examiner was appointed to investigate the causes of New Century's collapse. In early 2008, the Bankruptcy Examiner concluded that "New Century had a brazen obsession with increasing loan originations, without due regard to the risks associated with that business strategy." As noted in the New Century's Bankruptcy Examiner's investigation (the "Bankruptcy Examiner's Report")—which included a review of a large number of documents and 110 interviews of 85 fact witnesses—numerous members of New Century's board of directors and senior management stated that the predominant standard for loan quality was whether the loan could be sold in the secondary market to investors, not—as stated in the Offering Materials—whether a borrower could meet the obligations under the terms of a loan. Indeed, according to the Bankruptcy Examiner's Report, New Century's Chief Credit Officer said that in 2004 New Century had "no standard for loan quality."

179. As reported by the Bankruptcy Examiner, reckless origination and underwriting of New Century loans was rampant. For example:

- In early 2006, one senior manager at New Century described the performance of a certain loan product as "horrendous."
- By 2004, New Century Senior Management became aware of spiking increases in Early Payment Default ("EPD") rates—where a borrower fails to make even the first several payments on a loan—suggesting that the loan should never have been originated in the first place. In every month following March 2006, the EPD rate exceeded 10%, reaching to as high as 14.95% by year end.

180. New Century's loan-production department trained mortgage brokers at the aptly-named "CloseMore University," which provided instruction to New Century employees on how to originate increasingly risky loans. Those instructions, however, were focused not on how to

distinguish the good loans from the bad, but rather on how to make even the bad loans seem good. For example, over 70% of New Century's loans had initial "teaser rates" that would increase over the life of the loan, but also allowed the reported debt-to-income ratio to be lower; over 40% of New Century's loans were underwritten on a "stated income" basis, but little or no effort was made to confirm that the stated income was reasonable; and New Century originated an increasingly high percentage of "80/20" loans (which includes a first-lien mortgage with a 80% loan-to-value ratio, with a second lien loan with a 20%-loan-to-value ratio, resulting in a combined financing of 100% of the mortgaged property), which reduced the owner's equity in the mortgaged property, but allowed the reported loan-to-value ratio of the senior loan to be lower. Often, these different risk characteristics were combined into a single loan, resulting in a "layering" of the risk of the loan.

181. The New Century Bankruptcy Examiner concluded that statements in New Century's SEC filings declaring that "regardless of document type, New Century designed its underwriting standards and quality assurance standards to make sure that loan quality was consistent and met its guidelines" were "not supportable." Rather, the Bankruptcy Examiner concluded that "New Century did not produce 'high quality' loans or have 'high origination standards.'"

182. The statements in the ProSupp for this Transaction, quoted elsewhere in this Complaint, regarding New Century's underwriting practices and guidelines, which represented the New Century-originated mortgage loans as "originated consistent with and generally conform[ed] to the New Century Underwriting Guidelines' . . . loan programs," parallel the false statements in New Century's SEC filings and are equally false and misleading.[17]

---

[17] Additionally, claims asserted against New Century for making false or misleading statements of material fact regarding New Century's purported prudent underwriting guidelines have been sustained

183. As described in the Bankruptcy Examiner's Report, in New Century's wholesale division—which accounted for the vast majority (approximately 85%) of New Century's loan originations—the regional managers who had lending authority could manipulate the appraisal process by overriding internal appraisers' decisions. Moreover, the regional managers' compensation was not tied to loan quality, but was rather based on the volume of loans originated, providing incentive to inflate appraisal values in order to increase origination of New Century loans.

184. As revealed in a 2005 internal New Century audit disclosed in the Bankruptcy Examiner's Report, 18 of 77 (or 23%) of the loans reviewed at one Sacramento fulfillment center had "exceptions with either the appraisal conducted or the review of the appraisal submitted with broker-provided loans or the review appraisal conducted by New Century's Appraisal Department." The results of that audit were not an anomaly. According to the Bankruptcy Examiner, the results of New Century's own loan quality audits of underwriting procedures, account manager review/approval, appraisals and funding "were dismal." As reported by the Bankruptcy Examiner, of nine branches audited by New Century in 2005, none were rated satisfactory, seven were rated unsatisfactory and two were rated as needs improvement.

185. The Congressional Financial Crisis Inquiry Commission ("FCIC") also investigated New Century and reached similar conclusions. More specifically, the FCIC found:

> New Century—once the nation's second-largest subprime lender—ignored early warnings that its own loan quality was deteriorating and stripped power from two risk-control departments that had noted the evidence. In a June 2004 presentation, the Quality

---

under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, and Section 11 of the Securities Act of 1933. *See In re New Century*, No. CV 07-00931 DDP (JTLx), ECF No. 333, at 34 (C.D. Cal. Dec. 3, 2008) ("This Court likewise agrees . . . that Plaintiffs' Complaint alleges sufficient facts that the statements were material misrepresentations of New Century's loan quality and underwriting practices.")

> Assurance staff reported they had found severe underwriting errors, including evidence of predatory lending, legal and state violations, and credit issues, in 25% of the loans they audited in November and December 2003. In 2004, Chief Operating Officer and later CEO Brad Morrice recommended these results be removed from the statistical tools used to track loan performance, and in 2005, the department was dissolved and its personnel terminated. The same year, the Internal Audit department identified numerous deficiencies in loan files; out of nine reviews it conducted in 2005, it gave the company's loan production department "unsatisfactory" ratings seven times. Patrick Flanagan, president of New Century's mortgage-originating subsidiary, cut the department's budget, saying in a memo that the "group was out of control and tries to dictate business practices instead of audit."

186. A former Vice President of Corporate Risk at New Century testified before the FCIC in April 2010 that appraisers "fear[ed]" for their "livelihoods" if they failed to provide New Century with a lofty valuation of the collateralized property. As such, New Century's appraisers "would find properties that would help support the needed value rather than finding the best comparables to come up with the most accurate value." Some appraisers would remove boards from boarded-up windows or omit certain other important elements of the property when taking photographs of the property in order to support the inflated valuation.

187. Finally, a complaint filed in Part 3 of this Court by certain investors in the same Transaction at issue here -- MSAC 2007-NC4 -- provides further corroboration of FGIC's allegations. According to the Amended Complaint in that action, *Allstate Insurance Company v. Morgan Stanley*, Index No. 651840/2011, counsel for these investors (who invested in MSAC 2007-NC4 and other transactions) interviewed numerous former New Century employees, who confirmed the conclusions reached by the New Century Bankruptcy Examiner and the FCIC.

188. Morgan Stanley sought dismissal of these claims, attacking the legal sufficiency of what it characterized as Allstate's "principal allegation" that "Morgan Stanley misrepresented the underwriting and appraisal guidelines of the mortgage originators" in the relevant ProSupps.

Morgan Stanley also attacked the legal sufficiency of Allstate's allegation that the offering materials were materially misleading as to "the due diligence that [Morgan Stanley] conducted into the loan originators and the underlying loans." The Court denied Morgan Stanley's motion to dismiss, sustaining the legal viability of a fraud claim based on these misstatements in the same ProSupp at issue here. *Id.*, NYSCEF Doc. No. 48, entered Mar. 15, 2013 (Bransten, J.). Morgan Stanley appealed from this ruling (focusing on other aspects of the decision) and the First Department unanimously affirmed Justice Bransten's decision on May 14, 2014.

189. The confidential witnesses cited in Allstate's complaint explained that loans were not originated according to New Century's stated underwriting guidelines, but were instead originated without regard to a borrower's ability to repay. For example, according to CW 2, a former New Century fraud investigator and senior loan underwriter who examined numerous New Century mortgage loans from January 1999 until April 2007, New Century "started to abandon prudent underwriting guidelines" at the end of 2003 in order to "push more loans through." According to CW 2, New Century essentially "stopped underwriting."[18] As explained by CW 5, a former New Century account manager employed by New Century from November 2004 until September 2006 in Englewood, Colorado, New Century was very "loose" with its underwriting rules, routinely waived certain underwriting conditions, and often ignored its own underwriters' findings or decisions. CW 5 stated that a lot of the loans originated were "fraudulent," and that CW 5 would bring loans with falsified verifications to the attention of CW

[18] According to the *Allstate* complaint, CW 3, a former New Century Vice President, Corporate Finance, agreed that New Century began to lower credit standards beginning in 2003. At that time, New Century changed its practice with respect to stated income loans, which came to be known in the industry as "liar's loans." CW 4, a former New Century senior training development manager employed by New Century from March 2003 until March 2006, explained that underwriters often allowed borrowers to resubmit a rejected full-documentation loan (which had been rejected because the borrower's income was too low) as a "stated loan" with a new and higher income, which was then approved. CW 4 stated that this practice was "taboo" in the mortgage industry but routinely occurred and was a "running joke" at New Century.

5's operations and sales manager, but was told to just issue the loans in order to "make our numbers." CW 6, a former New Century Vice President and Regional Manager, employed by New Century from September 1996 until May 2007, explained that New Century made very low quality and extremely risky loans, noting that: "If you had a heartbeat, we would give you a loan."

190. According to the *Allstate* complaint, CW 7, another former New Century underwriter and risk manager employed at New Century from December 2001 until April 2007, explained that exceptions to underwriting guidelines were endemic and it was "more about quantity than quality," with the attitude being "get the volume on; get the volume on." Indeed, CW 7 reported that nine out of ten loans that CW 7 recommended denying were nevertheless approved by management.[19]

191. The *Allstate* complaint alleges that CW 10, a former New Century production risk manager employed by New Century from April 2002 until April 2007 in Woodland Hills, California who performed quality control audits on funded loans and, after February 2007, on loans claimed for repurchases, stated New Century's loans had gotten "riskier and riskier." According to CW 10, mortgage underwriters were told not to deny loans and, if they were denied, applications would simply be re-worked and signed off by operations managers. CW 10 stated that the most "questionable loans" were those with exceptions required to be signed off on by management and those were about half of the total volume of loans CW 10 generally reviewed. CW 10 reported that "a lot" of the time CW 10 recommended denying a loan, but CW

---

[19] CW 8, a former New Century Vice President, Regional Manager, employed by New Century from October 1999 until March 2007, stated that starting in 2003 and 2004, roughly half of New Century's loans contained exceptions. CW 9, a former New Century underwriter employed by New Century from May 2005 to March 2006 in Itasca, Illinois and, previously, from 2000 until 2003 in Cincinnati, Ohio, explained that he could not recall the last loan that he looked at that did not have an exception.

10's operations manager "constantly" overrode CW 10—mainly because operations and branch managers received bonuses for the number of funded loans they pushed through. According to CW 10, a running joke at New Century was that, "If you could fog a mirror, you can get a loan at New Century."

192. The *Allstate* complaint alleges that, according to CW 11, a former New Century regional Vice President, employed by New Century from 1999 until May 2007, the mindset of New Century's operations division was that it did not matter if a loan was a good loan or a bad loan—as long as New Century could sell the loan for securitization into RMBS, it was a good loan. CW 11 explained that New Century booked "ugly" loans and it was about "volume, volume, volume ... pretty reckless volume."

193. The *Allstate* complaint also cites evidence that statements in the ProSupp about the appraisal process used by New Century, which are quoted elsewhere in this Complaint, were materially false and misleading. This evidence supports the conclusion that, in order to increase loan origination volume, New Century routinely hired biased appraisers and used inflated appraisals as a matter of course to issue loans to borrowers who would not otherwise qualify for the mortgage. These allegations corroborate FGIC's findings with respect to inflated appraisals and misstated CLTV ratios.

194. The *Allstate* complaint alleges that former New Century employees interviewed by Allstate's counsel confirmed that loans were routinely originated using improperly inflated appraisals. For example, CW 12, a senior vice president enterprise program manager for New Century in Irvine, California from July 2005 to April 2006 stated that he could "guarantee" that large appraisers used by New Century gave New Century "the benefit of the doubt," *i.e.*, provided an overly optimistic appraisal, in order to maintain New Century's business. As but

one example, CW 12 stated that an appraiser might photograph only one side of the house but not the side that was run down and falling apart in order to justify the inflated valuation. According to CW 12, these appraisal companies did not "want to piss off New Century" because they were compensated on volume.

195. Taken together, these allegations and findings in other proceedings provide corroboration for FGIC's allegation that the offering materials for the Transaction contained numerous false and misleading statements and omitted to disclose New Century's actual practices and the actual quality of New Century's loans – and that Morgan Stanley's warranties to FGIC about the truth of the statements in those offering materials were also false.

196. The ProSupp stated, among other things, that the Mortgage Loans were underwritten "in accordance with the underwriting standards" and that, to the extent exceptions to those standards are granted, they are granted only based upon "compensating factors."[20] These basic assurances about New Century, provided by Morgan Stanley in the ProSupp, are consistent with the assurances made in connection with the many other securitizations at issue in the numerous other lawsuits and investigations against it. In short, time after time New Century assured the public that its underwriting standards were rigorous, including that its exceptions process was based on legitimate compensating factors, and that its securitizations were funded with loans that met those standards. Those assurances were flagrantly wrong. The evidence in the public record of New Century's wholesale abandonment of its underwriting guidelines and related policies and procedures, including those relating to property appraisals, corroborates FGIC's findings here that Morgan Stanley breached the Transaction Warranties provided to FGIC

[20] *See, e.g.*, ProSupp at S-42.

because the statements made in the ProSupp about New Century's lending practices were materially false and misleading.

XI. PUBLIC FILINGS FURTHER REVEAL MORGAN STANLEY'S IMPROPER SECURITIZATION PRACTICES – AND CORROBORATE FGIC'S FINDINGS

197. The analysis by FGIC's consultants, which found a breach in every single one of the hundreds of loan files they reviewed, is evidence that Morgan Stanley's representations about its diligence and review process were fraudulent and constituted a breach of its Transaction Warranties. FGIC's conclusions in this regard are corroborated by evidence from public filings and government investigations confirming that Morgan Stanley did not use its diligence and review processes for keeping bad loans out of securitizations. To the contrary, these public sources reveal that Morgan Stanley's business strategy was to maximize the number of loans securitized without regard to quality. If Morgan Stanley's diligence process served any purpose at all, it was not to ensure the quality of the loans that it sold to securitization trusts, as represented, but was to enable Morgan Stanley to negotiate a better price for purchasing defective loans from the originators. This evidence from the public domain, which only came to light after the closing of the Transaction, corroborates FGIC's findings that Morgan Stanley committed fraud and breached the Transaction Warranties that it provided to FGIC because the statements contained in the ProSupp concerning Morgan Stanley's business practices were materially false and misleading.

198. In January 2011, the FCIC issued a report shedding light on Morgan Stanley's diligence practices in securitization transactions. The FCIC specifically investigated one of the due-diligence contractors that Morgan Stanley employed, Clayton Holdings ("Clayton"). Clayton classified loans that it reviewed into three groups: Grade 1, 2, or 3. Grade 1 loans were those that met guidelines, while Grade 2 loans were those that failed to meet guidelines but were

nevertheless approved because of compensating factors. Grade 3, loans, however, were those that failed to meet guidelines and did not have sufficient compensating factors, and therefore were not approved by Clayton.[21] According to documents produced by Clayton for the FCIC Report, Clayton rejected 16% of the loans it reviewed for Morgan Stanley.[22] Nevertheless, Morgan Stanley waived in and thereafter securitized 56% of these Grade 3 loans, despite the fact that its due-diligence contractor had specifically found that the loan had no redeeming features and could not meet guidelines.[23]

199. Tony Peterson, a vice president in Morgan Stanley's due-diligence group, supported the FCIC's findings. In an interview with the FCIC, Peterson testified that Morgan Stanley's own due-diligence team undermined Clayton's review by routinely rejecting and re-designating the grades assigned by Clayton.[24] What, then, was Clayton's role? According to its former president Keith Johnson, Morgan Stanley used Clayton for one purpose: to use its findings of underwriting defects as a bargaining chip to negotiate lower prices for loans that Morgan Stanley acquired for securitization and to thereby boost Morgan Stanley's own profits. Johnson testified before the FCIC as follows:

> I don't think that we added any value to the investor, the end investor, to get down to your point. I think our only value was done in negotiating the purchase

---

[21] FCIC, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011) ("FCIC Report") at 166.

[22] Clayton All Trending Report at 8, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0923-Clayton-All-Trending-Report.pdf.

[23] *Id.*; *see also* Assurance of Discontinuance, *In re: Morgan Stanley & Co. Inc.,* No. 10-2538 (Mass. Suffolk County Super. Ct. June 24, 2010) ¶ 28 ("During 2006 and 2007, Morgan Stanley waived exceptions on and purchased a large number of the loans found by Clayton to violate guidelines without sufficient compensating factors. In the last three quarters of 2006, Morgan Stanley waived more than half of all material exceptions found by Clayton (there can be more than one material exception on one 'exception' loan), and purchased a substantial number of New Century loans found by Clayton to violate guidelines without sufficient compensating factors.").

[24] Interview by FCIC with Anton Peterson, Morgan Stanley (Oct. 14, 2010), *available at* http://fcic.law.stanford.edu/interviews/view/228.

> between the seller and the securitizer. Perhaps the securitizer was able to negotiate a lower price, and could maximize the line. We added no value to the investor, to the rating agencies.[25]

200. Given its prioritization of quantity over quality, Morgan Stanley unsurprisingly acquired most of the loans it securitized from among the worst originators in the business. The federal Office of the Comptroller of the Currency issued a list in 2009 of the ten worst mortgage lenders in the ten metropolitan areas with the highest rates of foreclosure on loans made between 2005 and 2007. On the list was New Century, which originated all the loans underlying the Transaction at issue in this action.[26] Although Morgan Stanley was aware of certain deficiencies with New Century's practices as early as late 2005, it continued to do business with New Century for fear of losing one of its highest-volume clients.[27]

201. Finally, Morgan Stanley's improper mortgage-lending and securitization practices extended to the rating agencies as well. For example, Morgan Stanley routinely insisted that ratings agencies apply more favorable, but outdated, ratings models in rating Morgan Stanley's deals.[28]

---

[25] Interview with D. Keith Johnson, Clayton Holdings, LLC (Sept. 2, 2010) *available at* http://fcic.law.stanford.edu/resource/interviews.

[26] Worst Ten in the Worst Ten, OCC (Nov. 13, 2008) *available at* http://www.occ.treas.gov/news-issuances/news-releases/2009/nr-occ-2009-112b.pdf.

[27] Assurance of Discontinuance, *In re: Morgan Stanley & Co. Inc.*, No. 10-2538 (Mass. Suffolk County Super. Ct. June 24, 2010) ¶ 32 ("Starting in or around October 2005, in the course of reviewing and rejecting for purchase certain loans, Morgan Stanley became aware of problems in the quality of appraisals at New Century. The quality problems persisted through 2006 and 2007."); ¶ 25 ("In April 2006, as Morgan Stanley wrestled with the possibility of losing New Century's business, Morgan Stanley's subprime mortgage team discussed a number of possible responses to this situation. As a result of these discussions, one of Morgan Stanley's senior bankers purchased loans that Morgan Stanley's diligence team had initially rejected. According to Morgan Stanley's records, 228 loans were purchased in this way. Morgan Stanley's diligence teams began to be more responsive to New Century's desire to include additional loans in the purchase pools.").

[28] Amended Complaint, *Allstate Ins. Co. v. Morgan Stanley*, No. 651840/2011 (Sup. Ct. N.Y. County Sept. 9, 2011), ¶¶ 200-215.

XII. FGIC Has Been Significantly Harmed

202. The performance of the Transaction is consistent with the evidence of pervasive defects in and misrepresentations with respect to the Mortgage Loans and the business practices of both New Century and Morgan Stanley. Simply put, the Transaction has shown severe flaws. An overwhelming percentage of the Mortgage Loans have been written off or are severely delinquent, causing massive shortfalls in the cash flows of principal and interest needed to pay down the Insured Securities. Specifically, as of August 25, 2014, the total losses on the loans were more than $493 million (or approximately 47% of the original pool balance). The losses have caused severe shortfalls in amounts available for distribution to the holders of the Insured Securities.

203. As a result, FGIC will be obligated to pay hundreds of millions of dollars in claims under its Policy. In addition, FGIC has incurred and will continue to incur substantial amounts of fees, costs, and expenses in order to defend and enforce its rights in connection with the Transaction, including its rights under the Insurance Agreement and the R&W Agreement.

204. As discussed above, Morgan Stanley's pervasive breaches of its warranties – revealed by FGIC's reviews of the Mortgage Loans and demonstrated by the dismal performance of the Transaction – pierce the very heart of the bargain struck by the parties. Morgan Stanley did not transfer to the Trust Mortgage Loans having the represented attributes underwritten to the represented guidelines and protocols. Rather, the overwhelming majority of Mortgage Loans did not bear any resemblance to the loans that Morgan Stanley warranted would underlie the securities. Moreover, Morgan Stanley's due diligence and other policies and procedures purportedly implemented to ensure the quality of the securitized loans did not conform to Morgan Stanley's representations to FGIC, nor did the Mortgage Pool have the characteristics that Morgan Stanley warranted it would have.

205. Morgan Stanley thus materially breached the Insurance Agreement as a whole by its pervasive breaches of material warranties.

206. Morgan Stanley's misconduct entitles FGIC to, among other things, be (i) made entirely whole for being fraudulently induced to enter into the Insurance Agreement and to issue its Policy, and (ii) compensated for the incremental harm incurred as a result of its participation in the Transaction. At the very least, this relief requires the payment to FGIC of all payments required to be made in the future under its Policy, as well as the costs incurred in attempting to minimize its losses.

207. Morgan Stanley's conduct was fraudulent. Morgan Stanley's extensive misrepresentations and its perversion of the diligence process to extract discounts from originators, while knowingly selling defective loans to securitization trusts, constituted a serious breach of morals and represented such wanton dishonesty as to imply a criminal indifference to its civil obligations. Morgan Stanley's behavior was part of a pattern of misconduct, orchestrated by senior executives and repeated over multiple securitization transactions, which pattern was directed not just at FGIC, but at the investing public generally. Morgan Stanley's conduct helped trigger an enduring financial crisis that brought havoc to financial markets and resulted in the financial ruin of many businesses and individuals. As other courts have found, conduct of this nature, if proven, can justify an award of punitive damages.

FIRST CAUSE OF ACTION
(FRAUDULENT INDUCEMENT AGAINST ALL DEFENDANTS EXCEPT SAXON)

208. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

209. As set forth above, in response to FGIC's inquiries, and in communications and

statements provided to FGIC prior to FGIC's agreement to issue the Policy, Morgan Stanley made materially false statements and concealed material facts concerning (i) Morgan Stanley's business practices, (ii) New Century's business practices, (iii) the securitized loans, and (iv) the ratings for the Transaction issued by rating agencies.

210. Morgan Stanley knew that these statements were false and misleading at the time they were made.

211. Morgan Stanley intended for these false and misleading statements and omissions to induce FGIC's issuance of the Policy.

212. FGIC obtained contractual warranties affirming many of Morgan Stanley's pre-contractual representations to assure that FGIC could reasonably rely upon them.

213. FGIC reasonably relied upon Morgan Stanley's fraudulent statements and omissions when it agreed to enter into the Insurance Agreement and to issue the Policy.

214. By means of its fraudulent statements and omissions, Morgan Stanley deprived FGIC of the ability to evaluate the actual risk that it insured under its Policy.

215. If FGIC had known the true facts, it would not have agreed to participate in the Transaction or to issue its Policy.

216. As a result of issuing the Policy, FGIC has suffered and will continue to suffer damages, including paying and incurring claims under the Policy, in an amount to be proved at trial, that it is entitled to recover under the common law and New York Insurance Law § 3105.

217. Punitive damages are further warranted in an amount to be determined at trial.

SECOND CAUSE OF ACTION
(BREACH OF WARRANTIES AGAINST MSAC, MSMC AND MS)

218. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

219. FGIC entered into the Transaction and issued the Policy in reliance on the Transaction Warranties and Loan Warranties made by Morgan Stanley at the time of issuance of the Policy.

220. Morgan Stanley breached the Transaction Warranties and Loan Warranties.

221. As a result of Morgan Stanley's breaches of the Transaction Warranties and Loan Warranties, FGIC faced a materially greater risk of loss from agreeing to participate in the Transaction and to issue its Policy.

222. As a result of Morgan Stanley's breaches of the Transaction Warranties and Loan Warranties, FGIC has suffered and will continue to suffer damages, in an amount to be proved at trial, that FGIC is entitled to recover under the common law and under New York Insurance Law § 3106.

223. In addition, as a result of Morgan Stanley's breaches of the Loan Warranties, MSMC is obligated to repurchase the affected Mortgage Loans pursuant to Section 4(a) of the R&W Agreement.

THIRD CAUSE OF ACTION
(MATERIAL BREACH OF THE INSURANCE
AGREEMENT AGAINST MSAC, MSMC AND MS)

224. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

225. Morgan Stanley induced FGIC to enter into the Transaction and to issue the Policy by making the Transaction Warranties and Loan Warranties. The Transaction Warranties and Loan Warranties were false when made, at the time when Morgan Stanley procured FGIC's Policy.

226. Morgan Stanley's pervasive breaches of the Transaction Warranties and Loan Warranties constitute a material breach of the Insurance Agreement, materially increase FGIC's

risk of loss and damages within the coverage of the Policy, and are so substantial and fundamental as to defeat the object of the parties in entering into the Transaction.

227. As a result of Morgan Stanley's material breaches of the Insurance Agreement, FGIC has suffered and will continue to suffer damages, in an amount to be proved at trial.

FOURTH CAUSE OF ACTION
(BREACH AND FRUSTRATION OF REPURCHASE PROTOCOL AGAINST MSMC AND MS)

228. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

229. As of and after the close of the Transaction, Morgan Stanley discovered and had notice that the pool of Mortgage Loans was replete with loans that breached the Loan Warranties at the time of origination.

230. In a series of letters, FGIC has provided notice to Morgan Stanley of certain Mortgage Loans that breached the Loan Warranties at the time of origination, along with descriptions of breaches sufficient to require Morgan Stanley to repurchase the identified loans from the Trust.

231. Additionally, Morgan Stanley discovered or was provided actual, constructive and/or inquiry notice that numerous other Mortgage Loans breached the Loan Warranties based on its own knowledge of New Century's loan-origination practices, its review of loan files, and the allegations of systematic breaches made by FGIC and Freddie Mac, and made in other proceedings regarding New Century's lending practices.

232. MSMC has materially breached and frustrated its contractual obligations under Section 4 of the R&W Agreement and Section 2.02(k) of the Insurance Agreement by refusing to cure or repurchase all but a handful of the Mortgage Loans that breached the Loan Warranties at the time of origination, pursuant to the terms of the Repurchase Protocol.

233. As a result of Morgan Stanley's breaches of its repurchase obligations, FGIC has suffered and will continue to suffer damages, in an amount to be determined at trial.

FIFTH CAUSE OF ACTION
(FOR REIMBURSEMENT AGAINST MSMC AND MS)

234. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

235. Pursuant to Section 3.03(d) of the Insurance Agreement, MSMC agreed to reimburse FGIC for any and all charges, fees, costs, and expenses paid or incurred, including reasonable attorneys' fees, in connection with, among other things, enforcing, defending, or preserving FGIC's rights under the agreements governing the Transaction, including the Insurance Agreement and the R&W Agreement.

236. FGIC has incurred and will continue to incur numerous expenses, including attorneys' fees and expert fees, in order to enforce, defend, and preserve its rights under the relevant agreements.

237. MSMC, therefore, has an obligation to provide reimbursement to FGIC pursuant to Section 3.03(d) of the Insurance Agreement.

SIXTH CAUSE OF ACTION
(BREACH OF THE PSA AND SIDE LETTER AGREEMENT AGAINST SAXON AND MS)

238. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

239. Pursuant to Section 2.07 of the PSA, Saxon agreed to provide prompt written notice to MSMC and to the other parties to the PSA upon discovery of any breach of the Loan Warranties by MSMC.

240. FGIC entered into the Transaction and issued its Policy in reliance on Saxon acting as Servicer, which placed Saxon in position to discover breaches of the Loan Warranties, and on Saxon having the contractual obligation to provide notice of breaches of the Loan Warranties.

241. Saxon breached its obligations under the PSA by failing to provide notice of the breaches of Loan Warranties that it discovered throughout its tenure as Servicer.

242. Pursuant to Section 3.01 of the PSA, Saxon agreed to act as a prudent servicer and to make reasonable collection efforts for the benefit of FGIC.

243. FGIC entered into the Transaction and issued its Policy in reliance on Saxon complying with its obligations as Servicer to service the Mortgage Loans prudently and to make reasonable collection efforts.

244. Saxon breached its obligations under the PSA by failing to service the Mortgage Loans prudently and by failing to make reasonable collection efforts.

245. Saxon and FGIC entered into a Side Letter Agreement with respect to the PSA in which Saxon agreed to provide notice to FGIC of any further referrals of Mortgage Loans to Ocwen for subservicing, and to obtain FGIC's consent should Saxon transfer its servicing obligations to Ocwen.

246. Saxon breached these obligations by failing to provide FGIC notice of further referrals of Mortgage Loans to Ocwen, and failing to seek or obtain FGIC's consent to Saxon's transfer of its servicing obligations to Ocwen.

247. As a result of Saxon's breaches of its obligations under the PSA and Side Letter Agreement, FGIC has suffered and will continue to suffer damages in an amount to be proved at trial.

SEVENTH CAUSE OF ACTION
(BREACH OF WARRANTIES AGAINST SAXON, MSAC AND MS)

248. FGIC re-alleges and incorporates by reference paragraphs 1 through 207 of this Complaint.

249. FGIC entered into the Transaction and issued the Policy in reliance on the warranties made by Saxon and MSAC in the PSA at the time of issuance of the Policy.

250. MSAC and Saxon breached their respective warranties provided in the PSA.

251. As a result of Saxon's and MSAC's breaches of their warranties made in the PSA, FGIC faced a materially greater risk of loss from agreeing to participate in the Transaction and to issue its Policy.

252. As a result of Saxon's and MSAC's breaches of their warranties made in the PSA, FGIC has suffered and will continue to suffer damages, in an amount to be proved at trial, that FGIC is entitled to recover under the common law and under New York Insurance Law § 3106.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

- An award of all compensatory, consequential and punitive damages, to be proven at trial, for Morgan Stanley's fraudulent inducement of FGIC's participation in the Transaction and issuance of the Policy;

- An award of compensatory damages, and any other damages to be proven at trial, for Morgan Stanley's pervasive and material breaches of its representations and warranties, constituting a material breach of the Insurance Agreement and frustration of the parties' bargain;

- An award of compensatory damages, and any other damages to be proven at trial, for Saxon's breaches of its obligations under the PSA and its related Side Letter Agreement, and for Saxon's and MSAC's material breaches of their representations and warranties provided in the PSA;

- An order awarding reimbursement of FGIC's attorneys' and expert fees, and other costs and expenses paid and incurred in enforcing, defending, or

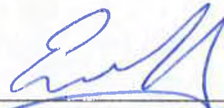
preserving its rights under the Operative Documents, plus interest, pursuant to Section 3.03(d) of the Insurance Agreement;

- An order compelling Morgan Stanley to repurchase those Mortgage Loans for which it has discovered or received actual, constructive and/or inquiry notice of breaches of the Loan Warranties, pursuant to Section 4 of the R&W Agreement;
- An order of prejudgment interest; and
- An order awarding FGIC such other and further relief as the Court deems just and proper.

Dated: New York, New York
September 23, 2014

Respectfully submitted,

PATTERSON BELKNAP WEBB & TYLER LLP



Erik Haas (ehaas@pbwt.com)
Henry J. Ricardo (hjricardo@pbwt.com)
1133 Avenue of the Americas
New York, NY 10036-6710
Telephone: (212) 336-2000
Fax: (212) 336-2222

Attorneys for Financial Guaranty Insurance Company