

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

AMBAC CREDIT PRODUCTS, LLC,

Plaintiff,

-against-

CITIGROUP INC., CITIGROUP GLOBAL
MARKETS LIMITED, and CREDIT SUISSE
ALTERNATIVE CAPITAL, INC.,

Defendants.

Index No. _____

SUMMONS

09602387

TO THE ABOVE NAMED DEFENDANTS:

YOU ARE HEREBY SUMMONED to answer the complaint in this action and to serve a copy of your answer on the plaintiff's attorney within twenty (20) days after the service of this summons, exclusive of the day of service or within thirty (30) days after the service is complete if this summons is not personally delivered to you within the State of New York. In case of your failure to appear, judgment will be taken against you on default for the relief demanded in the complaint.

FILED
AUG 03 2009
COUNTY CLERK'S OFFICE
NEW YORK

Courthouse News Service

Plaintiff designates New York County as the place of trial. The basis of venue is
CPLR §501 and §503.

DATED: New York, New York
August 3, 2009

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

<p>AMBAC CREDIT PRODUCTS, LLC,</p> <p style="text-align: center;">Plaintiff,</p> <p>-against-</p> <p>CITIGROUP INC., CITIGROUP GLOBAL MARKETS LIMITED, and CREDIT SUISSE ALTERNATIVE CAPITAL, INC.,</p> <p style="text-align: center;">Defendants.</p>
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Index No.
COMPLAINT

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Plaintiff Ambac Credit Products, LLC ("Ambac"), by its attorneys Quinn Emanuel Urquhart Oliver & Hedges, LLP, brings this complaint against Citigroup Inc., Citigroup Global Markets Limited ("CGML" and together with Citigroup Inc., "Citigroup"), and Credit Suisse Alternative Capital, Inc. ("CSAC"). Except where otherwise indicated as to its own actions and conduct, Ambac alleges upon information and belief as follows:

Nature of the Case

1. This case arises out of a fraud perpetrated by defendants to offload onto plaintiff Ambac nearly \$2 billion of potential liabilities associated with mortgage-backed and other securities through misrepresentations and omissions regarding the true nature of the risks that were being transferred. Defendants offloaded these risks on Ambac in June 2007 through several credit default swaps executed between Ambac and defendant CGML, a wholly owned subsidiary of defendant Citigroup Inc. The swaps concerned a collateralized debt obligation ("CDO"), created by Citigroup, named Ridgeway Court Funding II, Ltd. ("Ridgeway II"), that held approximately \$3 billion (face amount) in assets, many of which were ultimately backed by residential subprime, midprime and prime mortgages. Pursuant to the swaps (the "Ridgeway II

Swaps” or “Swaps”), Ambac agreed that it would cover shortfalls in certain of Ridgeway II’s obligations to the CDO’s “super-senior” noteholders if Ridgeway II’s assets failed to perform as expected.

2. In agreeing to enter into the Ridgeway II Swaps, Ambac relied upon numerous representations from defendants regarding Ridgeway II and the obligations that Ambac was undertaking.

3. First, Ambac relied upon representations by Citigroup and CSAC that the assets in the Ridgeway II portfolio had maintained their value during the six-month “ramp up” period during which they had been acquired. Specifically, shortly before the Ridgeway II deal closed in late June 2007, Citigroup and CSAC provided Ambac with a detailed report that purported to list a recent “mark-to-market” valuation for each asset that CSAC had previously acquired for the Ridgeway II portfolio. In that report, Citigroup and CSAC represented that, on average, those assets would attract prices from investors in the market that were approximately 96% of their face values — in other words, that the market prices for the assets had deteriorated by only about 4% from the time of their issuance. This information was critically important to Ambac since many of the assets had been acquired for the Ridgeway II portfolio months earlier, and prior to a number of events that had created volatility in the market prices for some mortgage-backed securities. Ambac thus relied upon the current market prices provided by Citigroup and CSAC as providing assurance that there had not been any significant deterioration in the market prices for the assets in the Ridgeway II portfolio that could have changed the economics of the deal, revealed any infirmities in the assets that had been selected, or rendered the transaction no longer economically viable.

4. Second, Citigroup and CSAC also represented to Ambac that it would be protected against loss by the fact that the assets in the Ridgeway II portfolio were being carefully selected by CSAC, Ridgeway II's purportedly independent collateral manager, through a "credit-intensive" investment approach that would "seek to protect against downside" and focus on "diversification of asset type, issuer and servicer." CSAC further committed to "[c]ompare relative value [of the assets selected] versus other available credits" to ensure that it was obtaining the best assets available in the marketplace. In addition to providing a written description of CSAC's supposed careful investment selection process, Ambac also held a meeting with CSAC at which CSAC's investment managers made a detailed presentation regarding the rigorous review that it was conducting of each and every asset before it was selected for inclusion in Ridgeway II's portfolio.

5. Third, Ambac relied upon statements and actions by Citigroup that were intended to convey to Ambac that Ridgeway II was being successfully marketed to interested third-party investors. These representations were material to Ambac's consideration of the Ridgeway II Swaps because validation that there was market interest was an important element of Ambac's underwriting process. Ambac would not have considered the Ridgeway II Swaps without comfort that the deal had been successfully marketed to third parties who would assume the "first loss" and other risk positions subordinate to Ambac. Citigroup purposefully conveyed this information to Ambac during the negotiation of the Swaps by twice substantially increasing the number of subordinated securities that were being issued by Ridgeway II — an action that could have no legitimate purpose other than responding to increased market demand for those securities. Citigroup then confirmed the purported significant demand for these subordinated investment positions when it announced that it had been able to "price" all of the subordinated

securities at 100% of par, which by industry convention meant that it had commitments from interested third parties to purchase at least 80% of all the offered securities.

6. Fourth, Citigroup made repeated representations to Ambac that Ridgeway II would be a particularly conservative investment vehicle because of stringent restrictions that would limit its collateral to "high grade" assets that had a very low chance of default. Citigroup further touted that the Ridgeway II collateral pool would include a significant percentage of assets that exceeded even the standards required to meet the definition of "high grade," with many of the assets having credit profiles that entitled them to the highest ratings available from the credit rating agencies.

7. Fifth, Citigroup made further representations to Ambac that the security and credit quality of each tranche of notes issued by Ridgeway II would be required to be confirmed by independent high-grade credit ratings issued by multiple ratings agencies as a condition of the deal closing. Those high-grade credit ratings, which Ambac understood would be based upon full disclosure by Citigroup to the ratings agencies of all material information pertaining to the credit quality of the assets, provided Ambac with further assurances of the safety and security of the Ridgeway II transaction.

8. Finally, Citigroup also represented to Ambac that it would have the substantial protection of a 35% subordination level in the Ridgeway II capital structure in light of the more than \$1 billion of investment positions that would be junior to the super-senior position for which Ambac was providing credit protection. This subordination protection effectively meant that, had the collateral been valued near par as represented by Citigroup, Ridgeway II assets would need to deteriorate by more than 35%, eclipsing all the investments of its junior,

mezzanine and senior noteholders, before Ambac would ever face its first dollar of liability under the Swaps.

9. Ambac relied upon all of these representations, among others, in deciding to enter into the Ridgeway II Swaps. If true, these representations provided Ambac with the strong assurances it required that its risk of loss under the Ridgeway II Swaps was remote and that the Swaps were a safe and conservative transaction for Ambac. The true facts, however, were vastly different from what defendants had represented them to be.

10. For example, the "mark-to-market" valuations claimed by Citigroup and CSAC were false and concealed the true deteriorating nature of the assets in the Ridgeway II portfolio. Citigroup and CSAC had represented to Ambac that, on average, the assets in the portfolio had shown market deterioration of around only 4% — thus signifying that the assets had outperformed the market during the deal's six-month "ramp up" period. In reality, and unbeknownst to Ambac, Ridgeway II's assets were substantially impaired and, on average, the drop in market price for the securities in the portfolio was about *five times* higher than represented, with a reasonable mark-to-market on the portfolio being no more than 79% of the face amount of the portfolio's assets. The deterioration was even more stark for the more than \$400 million of notes in the Ridgeway II portfolio that had been issued by previous Citigroup-created CDOs (and that CSAC had permitted Citigroup to offload into Ridgeway II), with a reasonable mark-to-market of those assets being less than 70% of their face amount. Indeed, having lost almost a third of their value, these Citigroup-originated assets were some of the most deteriorated assets in the entire Ridgeway II portfolio.

11. This undisclosed deterioration in the Ridgeway II portfolio had, unbeknownst to Ambac, radically changed the economics of the Ridgeway II transaction and rendered it no

longer financially sound by the time the deal closed. For example, despite the fact that the market value of the assets in the Ridgeway II portfolio were severely impaired at the time, Citigroup arranged for Ridgeway II to pay at or near the face price for all of the assets it acquired. This meant that Ridgeway II had paid significantly more for its assets than they were truly worth — especially with regard to the notes issued by previous Citigroup-created CDOs that had been sitting unsellable and deteriorating further on Citigroup's books. These off-market sales — many of which amounted to sweetheart deals for Citigroup — had the effect, unbeknownst to Ambac, of rendering Ridgeway II insolvent from its inception since its liabilities exceeded the true value of its assets on the day of its creation by more than \$550 million. Had Ambac been aware of this deterioration and Ridgeway II's substantial insolvency, it would not have entered into the Swaps.

12. Citigroup and CSAC's assurances as to the supposed careful selection of collateral for Ridgeway II's portfolio equally were false. In fact, CSAC had not selected Ridgeway II's assets on the basis of an independent "credit-intensive" analysis that sought to protect against "downside" and promote "diversification" but had rather allowed Citigroup to hijack the Ridgeway II portfolio for the purpose of dumping leftovers from Citigroup's prior CDO and residential mortgage backed security ("RMBS") offerings that it had been unable to sell. Ambac would come to learn that many of Ridgeway II's most toxic assets were, in fact, notes issued by prior Citigroup-created CDOs that had similarly been used as repositories for unsellable mortgage-backed securities sitting on Citigroup's trading desks. Stuck with massive amounts of these aging and unmarketable assets, Citigroup transferred them into the Ridgeway II portfolio as a means of getting them off Citigroup's books (and onto Ambac's) before the collapse of the mortgage securities market at the end of 2007. CSAC's representation that it

would seek out the best comparatively valued assets for the Ridgeway II portfolio was further rendered false by the undisclosed fact that more than a quarter of the portfolio had been selected purely to track a mortgage-backed securities index in order to create a hedge for Citigroup without regard to the credit quality of the particular assets selected.

13. Nor were Citigroup's representations that Ridgeway II was being successfully marketed to interested third-party investors any more accurate. In fact, notwithstanding all of the Citigroup activity intended to create an impression that there was substantial demand for the Ridgeway II subordinated notes, in reality, Citigroup sold only a small amount of the securities that Ridgeway II issued, and even most of those were only sold to other Citigroup-structured CDOs, some of which had, in turn, issued notes that Ridgeway II had purchased for its portfolio. Notwithstanding the fact that Ridgeway II had attracted no significant outside investors, Citigroup nonetheless pushed to close the Ridgeway II transaction for the overriding purpose of obtaining Ambac's protection on the \$2 billion Ridgeway II super-senior tranche. Had Citigroup truthfully disclosed that Ambac was to be essentially the only third party assuming any substantial risk in connection with the Ridgeway II transaction, and not compounded that deception by "upsizing" the transaction (thereby falsely implying there was additional market demand), Ambac would never have agreed to enter into the Swaps.

14. The existing deterioration in the Ridgeway II portfolio further rendered false Citigroup's representations that the assets in the Ridgeway II portfolio were "high grade" and that the closing of the Ridgeway II transaction would be conditioned upon all of the notes issued by Ridgeway II also receiving legitimate high-grade ratings from the credit ratings agencies. In fact, the assets in the Ridgeway II portfolio were high grade in name only, with many of them having a much more deteriorated credit profile than such a label connoted. And, the notes issued

by Ridgeway II were no more deserving of the high-grade ratings they received with Citigroup only being able to procure such ratings from the ratings agencies by withholding from them material information regarding the actual deterioration of Ridgeway II's assets. By doing so, Citigroup misrepresented to Ambac the actual credit quality of the Ridgeway II transaction, falsely presenting it as a legitimate and conservative investment vehicle.

15. Finally, all of these facts also meant that the 35% subordination that Citigroup had claimed would protect Ambac against losses did not exist. In fact, more than half of that subordination had already evaporated through the undisclosed decline in market value of the Ridgeway II portfolio without any corresponding decrease in the prices at which Ridgeway II purchased those assets. This left Ambac with a significantly diminished level of protection against facing losses under the Swaps.

16. Had Citigroup and CSAC not misrepresented and/or concealed these true facts, Ambac would never have agreed to enter into the Ridgeway II Swaps. Ambac therefore brings this action seeking to rescind the Swaps on the basis of fraudulent inducement. In the alternative, Ambac asserts claims for (i) fraud and negligent misrepresentation against Citigroup and CSAC seeking damages; (ii) fraudulent conveyance against Citigroup seeking to reverse the purchases by Ridgeway II of assets from Citigroup at prices in excess of fair consideration through which Ridgeway II was rendered insolvent; (iii) breach of fiduciary duty against CSAC seeking damages; and (iv) aiding and abetting against Citigroup and CSAC for each providing knowing assistance to the other in respect of their misconduct.

Jurisdiction and Venue

17. This Court has jurisdiction over Citigroup Inc. under CPLR §§ 301 and 302(a)(1) because Citigroup Inc. maintains its principal place of business in New York. This Court has jurisdiction over CGML under CPLR § 301 pursuant to an agreement between the parties. In Section 13 of the ISDA Master Agreement dated July 3, 2007, between Ambac and CGML (the "ISDA Master Agreement"), the parties agreed to subject themselves to jurisdiction in this Court on all matters relating to the Ridgeway II Swaps. This Court has jurisdiction over CSAC under CPLR §§ 301 and 302(a)(1) because it maintains its principal place of business in New York.

18. Venue is proper under CPLR § 501 because Ambac and CGML, agreed in Section 13 of the ISDA Master Agreement that venue for all matters relating to the Ridgeway II Swaps could lie in this Court. Venue is also proper under CPLR § 503 because Ambac, Citigroup Inc., and CSAC are located in New York County, New York. Additionally, venue is proper because many of the wrongful acts alleged here occurred in New York County, New York.

The Parties

19. Plaintiff Ambac is organized under the laws of Delaware with its principal place of business in New York, New York.

20. Defendant Citigroup Inc. is a corporation organized under the laws of Delaware with its principal place of business in New York, New York.

21. Defendant CGML is the London-based arm of Citigroup's pan-European investment bank and is organized under the laws of England.

22. Defendant CSAC is a corporation organized under the laws of Delaware with its principal place of business in New York, New York.

Factual Background

I. Collateralized Debt Obligations and Credit Default Swaps

23. Collateralized debt obligations or "CDOs" are special purpose vehicles formed by banks for the purpose of creating a form of structured credit through the issuance of notes secured by pools of collateral. CDO collateral can include various types of assets, such as residential mortgage-backed securities ("RMBS"), notes issued by other CDOs, or credit default swaps referencing those types of obligations. These assets, when performing, generate a stream of cash flows that are then used to pay the CDO's expenses and make interest and principal payments to the CDO's noteholders. Any remaining cashflows go to the CDO's equity investors.

24. CDOs generate the cash needed for the purchase of its collateral through the issuance of multiple classes of notes and equity interests that are sold to investors. The notes issued by a CDO do not all have the same level of risk. Rather, CDO notes are issued in "tranches" representing unequal interests in the collateral portfolio. This is achieved by creating a hierarchical structure of noteholders in the CDO, with senior debt tranches typically having rights to a higher priority of payment over junior tranches. The more senior tranches have first claim on the cash flows generated by the underlying asset pool, and generally only after any accrued obligations to the senior tranche are paid in full are the obligations on the more subordinate tranches paid. In this manner, junior tranches are "subordinated" to the senior tranches, thus protecting senior tranches against losses from any deterioration in the asset pool since the junior tranches will bear any shortfall in the cash flow generated by the CDO's collateral before it affects the more senior tranches.

25. Correspondingly, CDO notes do not all offer the same level of anticipated return to their purchasers. Yields on CDO notes are correlated to their expected level of risk. More junior tranches offer higher yields but have a greater chance of losing value because their position in the CDO structure exposes them to any initial deterioration in the collateral. The more senior tranches, on the other hand, receive lower returns because they benefit from greater subordination and thus are the last to be impaired if there is any shortfall in the payments generated by the collateral. Reflecting this lower level of risk, senior tranches are expected to receive the highest credit ratings from the credit ratings agencies at the time of their issuance, such as the AAA rating from Standard & Poor's Ratings Service ("S&P") or the equivalent Aaa rating from Moody's Investor Services ("Moody's), which are reserved for obligations where the "obligor's capacity to meet its financial commitment on the obligation is extremely strong" (in the case of S&P) or "are judged to be of the highest quality, with minimal credit risk" (in the case of Moody's).

26. At the very top of the CDO structure are one or more "super-senior" tranches, which normally form the largest piece of a CDO's capital structure. Since the super-senior tranches are protected by the subordination of the tranches below it — including even a subordinated yet still AAA/Aaa-rated "senior" tranche — they are expected to involve only a very remote chance of loss. This is especially true in "high grade" CDOs in which the CDO's underlying collateral itself is supposed to have only the low chance of default associated with obligations rated on average AA-/Aa3, and at least A-/A3 by S&P and Moody's, respectively. As noted by an analyst in November 2007, at the time of their creation, these "super-senior" tranches of CDOs were considered virtually risk-free, and the idea of write-downs was

unimaginable.”¹ Correspondingly, the super-senior tranches also generally pay the lowest yields of any of the notes in the CDO structure.

27. As a result of the very low returns, super-senior tranches were sometimes not marketed to third parties but were rather retained by the bank structuring the CDO as, essentially, the near risk-free byproduct of the CDO underwriting process that was left over after selling off the junior, mezzanine and senior notes to the CDO’s investors. In addition, because of their low trading value, the structuring bank would sometimes retain the super-senior tranche and simultaneously buy low-cost credit default swap protection. The structuring bank would then book the present value of the anticipated cashflows from this transaction, which is referred to as a “negative basis” trade, allowing it to realize it as present income.

28. One of the most important aspects of the CDO that impacts on its performance is the strength of the collateral thus making the manner through which its assets are selected and managed vital to its success. For actively managed cash flow CDOs, such as Ridgeway II, the CDO’s assets are selected and managed by a “collateral manager” that is chosen by the structuring bank. The assets are selected based upon the collateral manager’s experience and independent analysis and pursuant to certain “eligibility criteria” that are set forth in the CDO’s indenture and that define certain permissible characteristics of both the individual assets that may be selected as well as the overall portfolio profile. Most of the CDO’s assets are selected by the collateral manager in the “ramp up” period in the months prior to the CDO closing so that the vast majority of the portfolio has already been created as of the closing date. Since the CDO has not yet raised any capital during the ramp up period (or, indeed, even come into existence), the pre-closing acquisition of assets is funded pursuant to a CDO “warehousing facility” between the

¹ “CDOs: Super-senior is super bad”, *Euromoney* (Nov. 30, 2007).

collateral manager and the warehousing facility provider, which is usually the bank structuring the transaction. If the CDO fails to close, the warehousing facility provider is at risk for assets that had already been acquired for the CDO's portfolio. Upon the CDO closing, all of the assets that were acquired pursuant to the warehousing facility are transferred to the CDO at the prices at which they were purchased by the warehousing facility, with the warehousing facility provider receiving reimbursement via the funds raised by the CDO through its issuance of notes and equity. After the CDO closes, the collateral manager continues to purchase assets for the CDO portfolio from remaining proceeds and also manages the acquired assets pursuant to the terms of the CDO's indenture and a collateral management agreement between the CDO and the collateral manager setting forth the collateral manager's responsibilities.

II. Ambac's CDO Business

29. During the relevant time period, Ambac provided credit protection on obligations issued by CDOs pursuant to which Ambac would be obligated to make payments to the purchaser of the protection to the extent the CDO defaulted on its payments in regard to the particular obligation. This CDO protection was generally memorialized through the form of a credit default swap between Ambac and the party seeking the credit protection, which was sometimes the bank structuring the CDO. Ambac was only willing to consider providing CDO protection where the risk of loss on the obligations it was protecting was extremely remote. It thus generally restricted its CDO business to negative basis trades whereby Ambac would protect super-senior CDO tranches that were insulated from loss by the subordination of the junior, mezzanine and senior tranches of the CDO in exchange for a low return commensurate with the near-risk free nature of the transaction.

30. Ambac thus never, absent extenuating circumstances, provided protection on CDOs in which it was expecting to be the sole or predominant risk-taker with regard to the CDO's performance. Rather, Ambac would only provide protection on CDOs in which it understood that third-party investors were expected to take substantial investment positions in the notes issued by the CDO that were junior to Ambac's position and through which those third parties would bear the first losses to the extent the CDO did not perform as expected and losses materialized. The fees that Ambac received in connection with providing protection on such CDO obligations were commensurate with the very low risk that Ambac was willing to assume.

31. During the time periods relevant here, including with regard to the Ridgeway II transaction, Ambac's approach to evaluating the risk associated with the super-senior debt tranches of CDOs was consistent with industry standards and practice and focused on, among other things, the collateral manager and the assets included in the CDO portfolio. Ambac would perform a rigorous review of the collateral manager through on-site visits in which it would examine the manager's credit process and asset analysis capabilities, its financial resources and access to collateral, its performance record, its collateral selection procedures and its compliance and oversight controls. Ambac also investigated the CDO collateral that had been selected by the collateral manager by evaluating the nature of the underlying assets, and modeling and stress-testing the CDO's cash flows based upon assumptions regarding the credit quality of the underlying collateral derived from the current credit ratings assigned to each individual asset. Ambac would further run analytical models to estimate loss levels in the transactions, calculate their levels of risk and approximate their potential returns in a variety of scenarios. Because the structuring bank and the collateral manager had superior knowledge and superior access to detailed information and data about the transaction and the CDO portfolio, in conducting its

credit analysis, Ambac sought and reasonably relied upon certain information from the structuring bank and the collateral manager that assisted Ambac in assessing the structure of the transaction, the nature and credit quality of the underlying assets, the collateral manager's selection process, and third-party market validation of the transaction.

III. Citigroup Proposes the Ridgeway II Swaps

32. In January 2007, Citigroup approached Ambac with the request that Ambac sell Citigroup credit protection on the super-senior obligations of Ridgeway II, a purportedly high grade CDO that Citigroup was in the process of structuring. Citigroup represented to Ambac that it was structuring Ridgeway II with the intent of selling off the junior, mezzanine and senior notes to third-party investors but additionally wanted to enter into a negative basis trade with Ambac pursuant to which it would assume the super-senior risk that was to be senior in the structure to those investors.

33. Ridgeway II is what is referred to as a "hybrid" CDO, meaning that its collateral is comprised of both "cash" and "synthetic" assets. Cash assets are securities that the CDO actually purchases and owns. Synthetic assets are securities that the CDO does not actually own but that are created synthetically for purposes of the CDO's portfolio through credit default swap agreements between the CDO and a counterparty under which the counterparty agrees to pay the CDO similar returns to those that the CDO would receive if it owned the physical securities. In exchange, the CDO is required to pay the counterparty if the referenced securities fail to make required payments or decline in value. Thus, in essence, to provide the CDO with similar returns as if it actually owned the physical securities, the counterparty agrees to take a "short" position on the CDO's synthetic collateral under which it will be entitled to substantial payments from the CDO if the referenced securities fail to perform. In the case of Ridgeway II, Citibank, N.A., a

subsidiary of Citigroup Inc., served as the counterparty on all of the credit default swaps used to create Ridgeway II's synthetic collateral. In this role, Citibank N.A. stood to gain to the extent that the synthetic securities in Ridgeway II's portfolio declined in value.

34. Citigroup also informed Ambac that the collateral manager for the Ridgeway II transaction would be CSAC, a subsidiary of Credit Suisse Group, that was managing eleven CDO vehicles and had over \$13 billion under management. Under the transaction, Citigroup was also acting as the warehousing facility provider and thus had agreed to fund the acquisition of any assets that CSAC selected for the Ridgeway II portfolio in advance of the CDO closing.

35. Ambac's role in the Ridgeway II transaction was negotiated, in fits and starts, over a span of nearly six months. In early January 2007, Citigroup sent Ambac a preliminary investor term sheet, which it had prepared to distribute to potential investors in the CDO, that described the deal as a CDO that would invest in \$2 billion of "high grade" assets. At that time, Citigroup's proposal was to have Ambac provide credit protection that would "attach" at a level somewhere between 15% and 20% in the Ridgeway II structure, meaning that Ambac would essentially be absorbing all losses suffered by Ridgeway II beyond the first 15% to 20%, which losses would be borne by the junior, mezzanine and senior note tranches. In the ensuing months, Citigroup sent Ambac schedules of the assets that were in the process of being acquired for the Ridgeway II portfolio as well as revised term sheets indicating the deal had been upsized to \$2.5 billion and then to \$3 billion, making it one of the largest CDOs ever to be created.

36. After a few months of negotiation, Ambac rejected Citigroup's initial proposal of attaching at 15% to 20%, explaining that it did not provide Ambac with sufficient subordination protection to meet Ambac's low tolerance for risk. The parties' discussions then slowed for a period of time, before becoming more active again in May 2007. At that time, Ambac informed

Citigroup that it would only consider entering into the Ridgeway II deal if it had the protection of at least a 35% attachment point. Citigroup represented to Ambac that this was the greatest amount of subordination Citigroup had ever provided on a high grade CDO but agreed to Ambac's request. With Ridgeway II's total capital structure pegged at \$3 billion, Ambac's 35% subordination level meant that Ambac would end up protecting the senior-most \$1.95 billion (or 65%) of the structure. Citigroup structured Ridgeway II, which ultimately closed on June 27, 2007, to create a "super-senior" tranche that corresponded to the \$1.95 billion for which Ambac was willing to sell protection, with the junior, mezzanine and senior tranches of notes corresponding to the remaining \$1.05 billion subordinated portion of the structure.

37. The credit protection that Ambac sold Citigroup was documented through the Ridgeway II Swaps, a series of credit default swaps referencing the \$1.95 billion super-senior tranche of Ridgeway II. These swaps relate to exposure that defendant CGML — an entity wholly owned and controlled by Citigroup — assumed directly with Ridgeway II. Under the Swaps, Ambac provides credit protection to CGML on Ridgeway II's Class A1A, A1B and A1C Floating Rate Notes due 2047, which represented the \$1.95 billion super-senior tranche of the CDO. CGML bears the risk of losses on those notes and offsets that risk by entering into the swaps with Ambac referencing the same \$1.95 billion in obligations. Ambac would thus assume the risk of default on these notes and, in return, would receive a fixed payment based on their face amount.² Due to the protection provided by Ambac under the swaps, Ambac, and not

² The Class A1A Floating Rate Notes due 2047 were "unfunded." Operating like a liquidity facility, these notes were to be created only to the extent that Ridgeway II required additional funds because its assets had failed to perform as expected and it had insufficient cash to fulfill its obligations under its credit default swaps with Citibank N.A. related to the CDO's synthetic collateral. Thus, Citibank N.A. is the direct beneficiary of payments made to fund the Class A1A Notes, and therefore the indirect beneficiary of the protection provided by Ambac.

CGML (acting purely as an intermediary), would thus become responsible for any shortfalls in Ridgeway II's super-senior positions.

38. The fixed payments that Ambac was to receive under the Swaps were only a tiny fraction of the nearly \$2 billion of obligations that the Swaps were protecting. As a result, Citigroup knew that Ambac was unwilling to enter into the Ridgeway II Swaps without assurances regarding the creditworthiness of the portfolio and the validity and broader market acceptance of the transaction, and that Ambac had appropriate structural protections in the deal that made any risk of loss extremely remote.

39. To provide Ambac with the assurances that it required, Citigroup and CSAC made numerous representations about the Ridgeway II transaction and the risk that Ambac would be assuming, including the following.

Ridgeway II's Collateral Maintained A Mark-to-Market Value Near Par

40. Of critical importance to Ambac's consideration of the Ridgeway II Swaps was receiving current market values for the assets that were in Ridgeway II's portfolio as the deal approached closing in late June 2007. This information was vitally important to Ambac because it knew that the assets would be transferred into the Ridgeway II portfolio at whatever prices the assets had been acquired under the warehousing facility even if the market prices for the assets had declined between the time of their acquisition and the time the deal closed. Ambac thus needed to know the current market prices of the assets in the portfolio to understand whether any movement in those market prices during the structuring of the transaction had changed the economics of the deal, revealed any infirmities in the assets that had been selected, or otherwise rendered the transaction no longer economically sensible or viable.

41. Ambac had a heightened concern regarding such potential changes to the economics of the Ridgeway II transaction during its structuring because of the lengthy "ramp up" period during which its portfolio of assets had been acquired. Whereas the "ramp up" period for many CDO deals was three months or less, Ambac knew that Ridgeway II's assets had been acquired over a period that was at least twice as long. In fact, as early as March 21, 2007 — more than three months before the deal's closing date — Sohail Khan, a Citigroup director, had sent an e-mail to Ambac attaching a schedule listing over \$1.4 billion of assets that had already been purchased for the Ridgeway II portfolio. For this amount of assets to have been acquired by mid-March 2007, Ambac knew that Citigroup and CSAC had likely begun acquiring them under a warehousing facility several months earlier — some six months or more before the deal's closing on June 27, 2007.

42. Moreover, Ambac was aware that during this period from early-2007 to mid-2007 in which Ridgeway II's assets had been acquired by the warehousing facility, there had been certain market events, such as the April 2, 2007 bankruptcy filing of New Century Financial, the largest subprime mortgage originator, that had caused volatility in the market prices for some mortgage-backed securities. Ambac therefore insisted before entering into the Swaps that Citigroup and CSAC confirm that they had been able to select, and had selected, assets for inclusion in Ridgeway II that were outperforming the market during the ramp up period. It was thus essential for Ambac's participation in the Swaps that the Ridgeway II portfolio had maintained its value, which would have confirmed that there was a remote risk of the assets defaulting, that the economics of deal had remained sensible, that Ambac's 35% subordination would be intact and that the proposed transaction was near-risk free as Citigroup had represented.

43. In light of these concerns, Ambac was persistent about receiving “mark-to-market” information on the Ridgeway II portfolio in advance of considering whether to enter into the Ridgeway II Swaps. In response to Ambac’s requests, Citigroup ultimately sent Ambac a report on June 14, 2007 (the same day that Ambac conducted due diligence at CSAC and two weeks before the Swaps closed), that purported to list the “mark-to-market” of each asset that CSAC had acquired for the portfolio. Citigroup and CSAC together generated the information in this June 14 report based on CSAC’s purportedly independent selection of the assets and Citigroup’s purported knowledge of the market from its trading desk for RMBS and CDO securities.

44. The “mark-to-market” values that Citigroup and CSAC provided to Ambac were their representation as to the price at which a trader could actually sell the securities in the Ridgeway II portfolio in the open market. As Citigroup itself had described in a 2006 report entitled *A General Review of CDO Valuation Methods*, a Citigroup-generated mark-to-market is *“an indicative price at which the Citigroup trading desk anticipates another investor would purchase the security.”* As Citigroup’s own trading desk was a regular participant in the RMBS and CDO markets, and Citigroup was the underwriter for many of the securities that were selected for the Ridgeway II portfolio, Citigroup had superior knowledge of the actual prices at which the securities in the Ridgeway II portfolio, or securities very similar to those securities, were trading on the open market. In addition, since Citigroup was already holding all of the assets in the portfolio pursuant to the warehousing facility arrangement with CSAC, it was already under an obligation to value the assets for purposes of its own financial statements and therefore was already generating regular mark-to-market values on the portfolio.

45. As Citigroup and CSAC intended, the mark-to-market values in the June 14, 2007 report provided to Ambac (which were dated as of May 31, 2007) purported to give Ambac precisely the assurances that it required that Ridgeway II's portfolio had stood up exceedingly well to market forces over the preceding six months, and was intended to validate the careful process that Citigroup and CSAC claimed had been employed to select each asset in the portfolio. These values confirmed Ambac's faith that CSAC had done its job to select well performing collateral. Indeed, the marks reflected that, on average, the securities in the Ridgeway II portfolio would trade at approximately 96% of their face value as of May 31, 2007, less than a month before the Ridgeway II deal closed. This meant that the securities had declined in value by only about 4% since their issuance. It also meant that there was very little discrepancy between Ridgeway II's purchase price for the securities in its portfolio, which averaged just under 100% of their face value, and their value of 96% in the month before the deal closed. This amounted to a representation by Citigroup and CSAC that the economics of the transaction had not changed significantly over the six or more months during which the deal was structured and that the transaction was still economically sensible and viable. These mark-to-market valuations also amounted to a representation that the Ridgeway II collateral was maintaining its value better than similar collateral available in the market. Ambac reasonably relied upon these strong assurances from Citigroup and CSAC in deciding to enter into the Ridgeway II Swaps and would have refused to enter into the deal had they not been provided.

46. Not only did Citigroup provide marks to assure Ambac that the assets included in Ridgeway II's portfolio were outperforming the market, Citigroup also sought to assure Ambac, based on Citigroup's expansive experience in all the different financial products involving subprime loans, that any public tremors over subprime loans were exaggerated. For example, at

a dinner meeting on April 11, 2007 — during the period in which negotiations over the Ridgeway II were slowed and Citigroup was seeking to reinvigorate them — Michael Raynes, head of structured credit at Citigroup, asserted to Ambac representatives that concerns over subprime mortgages were “overblown” and that he “would buy them personally.”

Ridgeway II's Assets were Rigorously Selected By a Diligent Collateral Manager

47. Citigroup and CSAC also gave Ambac strong assurances regarding the careful process that had been and was being employed in the selection of the assets for the Ridgeway II portfolio. For example, on April 5, 2007, Citigroup sent Ambac an investor pitchbook (the “Ridgeway II Pitchbook”) that included an entire section entitled “Portfolio Construction and Management” setting forth in detail the purportedly careful and rigorous process that was utilized by CSAC to select each and every asset for the Ridgeway II portfolio. In that presentation, Citigroup and CSAC claimed that Ridgeway II’s collateral was carefully selected through a “credit-intensive” investment approach that would “seek to protect against downside” for Ridgeway II’s investors and focus on “diversification of asset type, issuer and servicer.” It further represented that CSAC engaged in a “bottom-up” rigorous review of each asset’s underlying collateral to “[e]xamine key collateral characteristics (e.g., FICO, LTV, IO’s, MTA’s, 2nd liens, etc.)” and “[s]crutinize detailed breakdown of collateral (e.g., by credit score, loan-to-value ratio, etc.)” It further promised that no investment decision was made without CSAC “[c]ompar[ing] relative value versus other available credits,” with the single most important factor that guided each investment decision being “Credit, credit, credit.”

48. CSAC made further representations to Ambac regarding this purportedly careful and independent asset selection process during a meeting at CSAC’s offices on June 14, 2007. At that meeting, which was attended by Michael Shackelford and Samir Bhatt, the two people

heading the team at CSAC responsible for the Ridgeway II portfolio, as well as by John Popp, the managing director and group head of CSAC's Leveraged Investment Group, CSAC described in detail the process it had supposedly used to select Ridgeway II's assets. (At the time of the meeting, approximately 90% of the portfolio had already been selected.)

Specifically, CSAC claimed to have performed a fundamental analysis of each asset, starting with an understanding of the asset's issuer and/or servicer, through looking at their operational capabilities, past performance and financial resources. CSAC claimed to have then performed a review of each asset's credit through evaluating borrower quality, FICO scores, loan-to-value, and pool-level credit enhancement. They also claimed to have generated loss curves for each asset utilizing a proprietary model which incorporated historic performance data from industry sources and to have run forecasting models that took all delinquencies more than 59 days to full defaults. Then, CSAC claimed to have stress tested each asset to determine the point at which it would incur losses to ensure that subordination levels would protect against existing levels of market defaults. Only after running this purported gauntlet of tests, CSAC claimed, would an asset then be considered for inclusion in the Ridgeway II portfolio. According to CSAC, this rigorous process had resulted in a "defensively managed" portfolio that provided a remote chance of loss and strong ratings stability.

49. Citigroup and CSAC also provided special assurances that CSAC's standard selection procedures would be followed even in respect of any assets that were purchased for the Ridgeway II portfolio from Citigroup itself. For example, the Ridgeway II Offering Circular, which Citigroup provided to Ambac in draft for the purpose of its consideration of the transaction (the "Offering Circular"), stated that Ridgeway II "will purchase Eligible Collateral Debt Securities [*i.e.*, portfolio assets] from Citi or any affiliate thereof only to the extent that

[CSAC] determines that such purchases are consistent with the investment guidelines and objectives of the Issuer," the purchases were at "fair market value," and were "otherwise on an 'arms length basis.'"

50. Citigroup and CSAC further sought to demonstrate the apparent success of CSAC's rigorous and independent collateral selection process through the provision of the mark-to-market values that Citigroup sent to Ambac on June 14, 2007 — the same day on which Ambac met with CSAC to discuss their collateral selection process. Those values purported to show that, notwithstanding certain volatility in the subprime market, the assets selected by CSAC through its touted selection process had outperformed the market by maintaining 96% of their face values.

51. As Citigroup and CSAC intended, Ambac relied upon these representations as providing strong confirmation that the Ridgeway II collateral had been and would continue to be carefully and rigorously selected so as to limit any possibility of the assets deteriorating to the point of Ambac ever facing any risk of loss. Without these representations as to CSAC's selection process, Ambac would not have agreed to enter into the Ridgeway II Swaps.

Ridgeway II was a Successfully Marketed Third-Party Investment Vehicle

52. During the course of negotiating the Ridgeway II Swaps, Ambac also relied upon repeated statements and actions by Citigroup that were intended to convey that Ridgeway II was a legitimate "investment vehicle" that was being successfully marketed and sold to third-party investors. These representations were essential to Ambac's underwriting process and decision to enter into the Swaps because they not only validated that there was significant third-party interest in Ridgeway II but they also signified that other potential investors — such as institutional banks

and sophisticated hedge funds — believed that assets that Citigroup and CSAC had selected for Ridgeway II still had near-par value despite the volatility in certain segments of the market.

53. On January 9, 2007, Mr. Khan sent Ambac a preliminary investor term sheet for Ridgeway II, which had been prepared to distribute to potential investors in the CDO. That term sheet, which was the first description of the deal that Ambac received, indicated that Ridgeway II was to be an “actively managed CDO” that would invest in \$2 billion of “high-grade mortgage-backed and asset-backed securities.” To fund those investments, the term sheet indicated that Ridgeway II would issue six tranches of debt and equity notes that were subordinated to the super-senior tranche, all carrying differing financial returns designed to appeal to a wide array of purchasers. Of the entire \$2 billion capital structure, the term sheet listed approximately \$340 million (17% of the capital structure) of such subordinated tranches of notes that were to be sold to third-party investors, with the remaining \$1.66 billion representing the super-senior portion of the structure. Based upon representations from Citigroup’s officers, and Citigroup’s creation of the January 2007 preliminary investor term sheet, Ambac reasonably understood Citigroup to be holding preliminary discussions in early 2007 with potential investors to gauge the amount of interest from third parties in participating in the transaction.

54. On March 27, 2007, Mr. Khan forwarded to Ambac an e-mail that had been distributed to Citigroup’s “Global CDO Salesforce” officially “ANNOUNCING RIDGEWAY COURT FUNDING II — HIGH GRADE ABS CDO BY CREDIT SUISSE ALTERNATIVE CAPITAL.” Attached to the e-mail that Mr. Khan forwarded was a revised preliminary investor term sheet that showed the Ridgeway II deal as having increased in size from the \$2 billion listed in the January 2007 term sheet to \$2.5 billion. The term sheet further indicated that the subordinated tranches — *i.e.*, the securities being marketed to third parties — had been increased

in size by almost 50% from \$340 million in the January 2007 term sheet to \$500 million (now 20% of the capital structure). The term sheet further showed other changes to the structure of the subordinated note tranches, including the levels of subordination that would protect each tranche against losses. This revised structure was also reflected in the Ridgeway II Pitchbook that Citigroup sent to Ambac on April 5, 2007. The significant increase in the Ridgeway II securities being marketed to third parties was an unmistakable indication by Citigroup that its initial meetings with third party investors had generated even more interest than Citigroup had originally anticipated, justifying the expansion in the marketed securities. The modifications to the structure of the tranches was also a clear demonstration by Citigroup of supposed investor interest since the only reasonable justification for such changes was to respond to investor demand.

55. Less than a month later, Citigroup reaffirmed to Ambac the large amount of interest that third party investors were expressing in the Ridgeway II securities when, on April 19, 2007, Mr. Khan forwarded Ambac an e-mail that had been distributed to the "Global CDO Salesforce" regarding the Ridgeway II deal, which announced with fanfare: "**** DEAL UPSIZED TO \$3BN ***." Attached to the e-mail was another revised term sheet, this one reflecting a further increase in the Ridgeway II capital structure to \$3 billion, with the subordinated tranches that were being sold to third-party investors having climbed to \$757 million (now slightly higher than 25% of the capital structure). This was more than double the amount of the Ridgeway II securities that Citigroup had been forecasting it would be able to sell to third parties as reflected in its January 2007 term sheet and was an increase of more than 50% from the term sheet distributed less than a month previous. The April 2007 term sheet also reflected further revisions to the structure of the subordinated note tranches, including further

changes to the subordination levels of several tranches and a change to the required ratings for one of the tranches. As Citigroup knew and intended, this further increase in the amount of Ridgeway II securities being marketed to third parties and the other modifications were understood by Ambac as yet more clear indications as to the supposed success that Citigroup was having in locating interested third-party investors.

56. Finally, on June 1, 2007 — after having twice significantly increased the amount and modified the structure of the Ridgeway II securities being marketed for sale to third parties — Mr. Khan forwarded an e-mail to Ambac announcing that Citigroup had officially “priced” all of the Ridgeway II notes, and had done so at 100% of the notes’ par values. In industry terms, the fact that Ridgeway II had been “priced” amounted to a representation by Citigroup that there had been sufficient commitments by third party investors to purchase Ridgeway II’s subordinated notes such that Citigroup could set the final market price at which each tranche of the notes would be sold. By industry practice, such final pricing is not set until there are firm commitments for the purchase of at least 80% of the priced securities offered to third parties. This industry practice had been enforced at Citigroup by the co-chief of collateralized debt obligations, Nestor Dominguez, who had, at one time, routinely demanded that the vast majority of the notes subordinate to the super-senior tranche be placed before he would allow a Citigroup CDO to be priced. Furthermore, the fact that each of the tranches was being priced at 100% of the par value meant that Citigroup had sold notes or was able to sell notes at or near their full face value, which was a further representation as to the strong market demand that Citigroup had purportedly found for the Ridgeway II notes.

57. As Citigroup had intended, Ambac relied on each of these representations as confirmation that Ridgeway II was a legitimate investment vehicle that was being successfully

marketed to third-party investors. As Citibank knew, the fact that Ridgeway II had been successfully marketed to such third parties was of material importance to Ambac since it was those third parties that would assume the risk of loss from any deterioration in the Ridgeway II collateral before such losses would ever impact Ambac. The participation of independent third party investors willing to assume such credit risk was an important component in validating Ambac's credit review of the transaction. If Ambac had not received such representations that outside third party investors had agreed to assume such first-loss positions, it would not have agreed to enter into the Swaps as that would have left Ambac as the sole outside party assuming risk in connection with the structure.

Ridgeway II's Collateral was Comprised Solely of "High Grade" Assets

58. In deciding to enter into the Ridgeway II Swaps, Ambac also relied upon Citigroup's representations that Ridgeway II was a particularly conservative investment vehicle because of stringent restrictions that Citigroup had imposed that limited the collateral portfolio to "high grade" assets. In the context of structuring a CDO, the term "high grade" refers to assets that have the low chance of default associated with debt securities holding at least an A-/A3 credit rating from S&P or Moody's. Such a rating, as S&P's and Moody's ratings definitions explain, is reserved for obligations that are "subject to low credit risk" (Moody's) where "the obligor's capacity to meet its financial commitment on the obligation is still strong" (S&P).

59. Citigroup touted the purported "high grade" nature of the Ridgeway II collateral portfolio repeatedly in the materials that it provided to Ambac to induce it to enter into the Ridgeway II Swaps. For example, each of the investor terms sheets that Citigroup sent to Ambac on January 9, 2007, March 27, 2007, and April 19, 2007 claimed that Ridgeway II would only "invest in a *high grade* mortgage-backed and asset-backed securities portfolio." The high-grade

nature of the Ridgeway II collateral was further emphasized by Citigroup in the Ridgeway II Pitchbook, which represented that “[100]% of the collateral in the [Ridgeway II] Portfolio will be rated at least [A3/A-] by Moody’s or S&P at closing.” Citigroup knew that Ambac would rely on the representations of safety and low risk that this “high grade” description conveyed in deciding whether to enter into the Swaps as well as in assessing the amount of subordination that it would require.

60. In addition, beyond claiming that Ridgeway II’s collateral portfolio would be “high grade,” Citigroup further represented to Ambac that the Ridgeway II portfolio would meet strict requirements regarding its Moody’s weighted average rating factor or “WARF.” In the CDO industry, the WARF is an indication of the credit quality of the collateral pool and reflects the cumulative probability of a CDO’s default. To determine the WARF, the rating for each asset in the collateral pool is converted into a number between 1 and 10,000 with a lower number representing a lower risk of default. For example, an asset with the lowest risk of default associated with a debt security rated Aaa by Moody’s is given a rating factor of 1, while assets with the still very remote risk of default associated with Aa2-rated or A2-rated debt securities are given rating factors of 20 and 120, respectively. (At the other end of the spectrum, a debt security that has the vulnerability to default associated with a below-investment grade credit rating by Moody’s of Ca or lower would be given a factor of 10,000.) The weighted average of those ratings factors is then calculated across the entire CDO portfolio to arrive at a WARF for the entire transaction.

61. Citigroup repeatedly represented to Ambac that Ridgeway II would have a maximum WARF of between 64 and 66, which represented an overall very secure portfolio of assets. These representations were contained in, among other communications, each of the

investor term sheets that Citigroup provided to Ambac, the drafts of the Ridgeway II offering circular, and the Ridgeway II Pitchbook. Citigroup's representations that Ridgeway II would maintain a maximum WARF in the mid-60s meant that, beyond each portfolio asset being *at least high-grade, the portfolio would also include a substantial number of assets with the even lower probability of default associated with debt securities bearing Moody's credit ratings of Aa2 or higher. This representation was further elaborated in the Ridgeway II Pitchbook, which provided a chart of the "Moody's Target Rating Distribution" which projected that approximately 45% of Ridgeway II's entire asset portfolio would hold Moody's ratings of Aa2 or higher, and 17% would hold Moody's highest Aaa rating.*

62. Based on these representations regarding the "high grade" assets in the Ridgeway II portfolio, a maximum WARF in the mid-60s, and a strong Moody's Target Rating Distribution, Citigroup intended Ambac to understand that the aggregate quality of the Ridgeway II collateral pool was high and the cumulative probability of default was low. These representations were material to Ambac's assessment of the Ridgeway II Swaps and had Ambac not been provided with these assurances regarding the overall credit quality of the Ridgeway II portfolio, it would have been unwilling to enter into the Ridgeway II Swaps.

Independent Credit Ratings Confirmed the Credit Quality of the Ridgeway II Notes

63. Citigroup further represented to Ambac that the security and credit quality of the notes that would be issued by Ridgeway II would be confirmed by independent credit ratings that each tranche of issued notes would be required to receive from S&P, Moody's, and Fitch Ratings Inc. ("Fitch") as a condition of the transaction ever closing. In fact, Citigroup represented in each of the preliminary investor term sheets that it provided to Ambac on January 9, 2007, March 27, 2007, and April 19, 2007, as well as in the Ridgeway II Pitchbook that it would be a

condition to closing that all classes of Ridgeway II's notes receive at least BBB/Baa2 investment grade credit ratings from each rating agency. By early June 2007, Citigroup had increased the minimum credit rating for the junior-most tranche from BBB/Baa2 to A-/A3. Specifically, in the drafts and final Offering Circular and Indenture that followed, Citigroup represented that Ridgeway II's issuance of notes would be conditioned upon the tranches of notes issued by Ridgeway II each receiving the following high-grade ratings:

Notes	Notional Amount	S&P	Moody's	Fitch
Class A1A Notes Class A1B Notes Class A1C Notes	\$1.95 billion	AAA	Aaa	AAA
Class A1X Notes	\$300 million	AAA	Aaa	AAA
Class A2 Notes	\$225 million	AAA	Aaa	AAA
Class A3 Notes	\$225 million	AAA	Aaa	AAA
Class A4 Notes	\$126 million	AAA	Aaa	AAA
Class A5 Notes	\$80 million	AA	Aa2	AA
Class B Notes	\$35 million	A+	A1	A+
Class C Notes	\$33 million	A-	A3	A-

Thus, Citigroup represented that (1) nearly 99% of the entire \$3 billion capital structure would receive high-grade or higher ratings; (2) the top 93% would receive the highest credit ratings reserved for obligations that have an "extremely strong" likelihood of repayment; and (3) the next 5% of the structure would receive credit ratings reflecting a "very strong" or "strong" likelihood of repayment. Ambac relied upon the fact that Ridgeway II would be required to obtain these independent credit ratings from S&P, Moody's and Fitch based upon Citigroup's provision of all material information relevant to Ridgeway II's credit quality, as providing yet further material assurances that Citigroup had structured Ridgeway II as a secure and conservative investment

vehicle. Had Citigroup not committed to obtain confirmation of Ridgeway II's credit quality from outside credit rating agencies, Ambac would not have agreed to enter into the Ridgeway II Swaps.

Ambac was Protected by 35% Subordination

64. Citigroup further represented to Ambac during the negotiation of the Ridgeway II Swaps that, as a consequence of the \$1.05 billion in notes that would be subordinated to Ridgeway II's super-senior obligations, Ambac would have virtually no risk of any loss. The more than \$1 billion in notes junior to the positions for which Ambac would be providing protection reflected a 35% subordination, meaning that Ridgeway II would need to deteriorate by 35% and that every class of subordinated notes would have to suffer complete losses of principal before Ambac was exposed to even one dollar of loss under the Swaps. From Ambac's initial rejection of the 15% to 20% attachment point, Citigroup knew that the high level of subordination was critical to Ambac's decision to participate in the transaction.

65. On June 22, 2007, Ambac's credit committee, which was responsible for approving all of its CDO transactions, concluded its final review of Ridgeway II and provided its approval for Ambac entering into the Swaps. In making that decision, the Ambac credit committee relied upon the numerous representations that Citigroup and CSAC had made with regard to the factors that would protect Ambac against potential losses on the Swaps, including that the collateral had maintained near-par mark-to-market valuations during the structuring of the transaction, the collateral had been selected by CSAC using an independent and rigorous selection process, there were significant third-party investors for the subordinated notes, the Ridgeway II collateral had a low risk of default consistent with it being "high grade," the credit quality of the issued notes would be confirmed by independent credit ratings, and Ambac would have a 35% subordination level.

IV. Citigroup and CSAC's Fraudulent Misrepresentations Regarding Ridgeway II

66. In fact, the representations Citigroup and CSAC made to induce Ambac to enter into the Ridgeway II Swaps were false and misleading. The true facts paint a vastly different picture of the transaction and risks than had been represented to Ambac.

A. Citigroup and CSAC's "Mark-To-Market" Valuations Were False

67. The June 14, 2007 mark-to-market valuations that Citigroup and CSAC provided to Ambac were materially false in that they grossly overstated the contemporaneous value — and thus creditworthiness — of Ridgeway II's collateral and concealed substantial deterioration that had occurred in the portfolio. At the time that Citigroup provided those marks to Ambac, it was well aware that it could not trade the securities it had included in the collateral portfolio at anywhere near par value and that there was no basis to justify a mark-to-market of, on average, about 96% of the face value of the securities. Citigroup nevertheless maintained this illusion to protect its undisclosed yet overriding purpose in structuring the Ridgeway II transaction: to offload onto Ambac nearly \$2 billion worth of risk associated with toxic securities in the Ridgeway II portfolio so that Citigroup could get those exposures off its own books.

68. As Ambac would only later learn, the genesis for Ridgeway II (along with a number of other contemporaneous Citigroup-structured CDOs) had come from the desperate position in which Citigroup found itself as 2006 drew to a close. Following the fast and furious pace that Citigroup's RMBS and CDO securitization business had been maintaining, Citigroup's warehouse of subprime assets being held for CDO securitizations had swelled to almost \$30 billion during the fourth quarter of 2006. A substantial portion of these warehoused assets consisted of unsold securities from Citigroup's own prior RMBS and CDO securitizations.

69. Around the same time, Citigroup had already concluded that there was an impending crisis that was going to imperil the value of the massive amount of assets it was holding on its books. In fact, Citigroup was one of the few parties uniquely situated to have had the full perspective at that time on the looming mortgage crisis since it was a leading originator of residential subprime, midprime and prime mortgages and understood how changes in the housing market and lending standards were going to affect existing mortgages. Citigroup doubled its mortgage origination business between 2002 and 2006 — increasing its originations from \$73 billion in 2002 to over \$140 billion in 2006, becoming the fourth largest mortgage originator in the United States by market share. While prime mortgages remained a central aspect of Citigroup's consumer lending business, mortgage origination growth was driven primarily by Citigroup's expansion in midprime and subprime lending. For example, Citigroup's subprime mortgage origination in 2006 increased by 85% over 2005 levels to approximately \$38 billion. Thus, these increases reflected an expansion of the types of mortgages Citigroup marketed to consumers and a decision to market its mortgage products to consumers with riskier credit profiles.

70. As a result of its massive mortgage business, Citigroup (unbeknownst to Ambac) had come to understand that a large number of the nonprime mortgages originated in 2005 and 2006 — many of which were collateralizing the RMBS and CDO securities held on Citigroup's books — were headed for default. Indeed, unbeknownst to Ambac, Citigroup began increasing its loan-loss reserves at the beginning of 2007, as it began to see increased loan delinquencies. In addition, as Citigroup's CFO Gary Crittenden would disclose months after Ridgeway II closed (but as was then unknown to Ambac), by January 2007 Citigroup had already begun hiring "over

1,700 collectors and recovery staff in our U.S. consumer businesses, of which over 560 were for mortgages in U.S. consumer lending.”

71. Citigroup also understood the ripple effect that this burgeoning crisis would have on the RMBS and ultimately CDO markets, as Citigroup was also one of the leading structurers and underwriters of RMBS and CDO securitizations and had intimate knowledge of the markets for those securities. Citigroup’s mortgage business served as a direct channel to its securitization business. For example, in the third quarter of 2006, Citigroup reported a \$57 billion increase in investments. Explaining this enormous increase during an analyst call, then-CFO Sallie Krawcheck stated:

I think part of that has been that we have been moving some of the loans in our consumer lending portfolio into mortgage-backed securities. What the team has been doing ... rather than necessarily sell to whole loan, [is] to turn some of them into mortgage-backed securities, which we then sell a good portion of, but we can hold on the balance sheet. So, movement in that has been causing some of that, as well as an increase in mortgage-backed securities overall.

72. Citigroup’s internal forecast of the meltdown in the securitization markets was reflected in a Citigroup analysis that was prepared in early 2007 (but not publicly disclosed until November 2007), titled “CDO Losses Under Different Model Scenarios in Sub-Prime,” in which Citigroup forecasted that an expected 2% decline in housing prices would render essentially worthless all of the junior, mezzanine and senior tranches in Citigroup’s CDOs, and would substantially impair even the super-senior tranches.

73. With \$30 billion of aging assets sitting on its books, Citigroup understood that this internally forecasted deterioration of the CDO market was a ticking time bomb for Citigroup. Therefore, in a last-ditch effort to avoid as many of the losses as it could on its warehouse of deteriorating assets, Citigroup began feverishly repackaging many of these investments into what it understood would likely be a final round of CDO structures, the largest

of which was Ridgeway II. The impact of this effort was reflected in the portfolios of these CDOs which were marked by a higher concentration of notes issued by other CDO securitizations, especially Citigroup's. For example, while on industry average, 20% of high grade CDO assets consist of other CDO's notes as collateral, Ridgeway II contained a concentration nearly twice as high. Moreover, much of the CDO notes in the Ridgeway II portfolio consisted of the unsold notes from Citigroup's own prior issuances.

74. Citigroup's chief financial officer, Gary Crittenden, would later allude to this successful strategy of getting such risks off its books in an earnings call held just one month after Ridgeway II closed. Responding to a question regarding the reduction in Citigroup's subprime mortgage-related exposure, Crittenden explained:

Think about this as the CDOs, the CLOs, and the secured assets that we hold on our balance sheet. *I think our risk team did a nice job of anticipating that this was going to be a difficult environment, and so set about in a pretty concentrated effort to reduce our exposure over the last six months.*

The time period that Crittenden was referring to in which Citigroup had "anticipated" the "difficult environment" and was engaged in a "concentrated effort" to offload its exposures was precisely the period in which it was arranging for Ambac to assume billions of dollars of Citigroup's risk through writing credit protection on Ridgeway II.

75. Thus, at the time that Citigroup provided mark-to-market valuations to Ambac in June 2007, Citigroup had already anticipated the looming crisis and knew that there was no market interest in the toxic securities it had included in the Ridgeway II collateral portfolio. Citigroup also knew there was no justification for a mark-to-market valuation of, on average, about 96% of the face value of the securities in the Ridgeway II portfolio. In reality, the assets were substantially impaired and the true drop in the market price for the portfolio was about *five*

times higher than what Citigroup had represented to Ambac, with a reasonable mark-to-market valuation, on average, being no more than 79% of the face value of the assets.

76. The CDO assets in the Ridgeway II portfolio that had come from previous Citigroup-created CDOs reflected even greater deterioration, with a reasonable mark-to-market on the more than \$400 million of recycled Citigroup CDO securities in the portfolio being less than 70% of their face amount, whereas Citigroup's June 14 mark-to-market had reported this subset of the portfolio as still retaining 91% of its value. Citigroup and CSAC were particularly aware of the substantial undisclosed impairment among this subset of assets, having specifically earmarked them for inclusion in Ridgeway II as a means of offloading Citigroup's exposure onto Ambac. Furthermore, since these were all Citigroup underwritten securities, Citigroup was intimately aware of the actual prices at which each of them was trading and knew that the June 14 mark-to-market vastly overstated the prices at which any transactions were actually taking place.

77. Nonetheless, notwithstanding this substantial undisclosed impairment, Citigroup arranged for Ridgeway II to pay, on average, almost 100% of the face price for all of the assets included in its portfolio. As a consequence of Citigroup's conduct, Ridgeway II paid significantly more for its assets than they were truly worth — especially with regard to the notes issued by previous Citigroup-created CDOs — rendering Ridgeway II insolvent from its inception. Indeed, the difference between the near-100% of face value that Ridgeway II paid for its assets and the 79% of their face value that was their true market value almost a month before closing represented a market loss to Ridgeway II before the transaction ever closed of more than \$550 million. This represented a substantial change to the economics of the transaction that was concealed from Ambac by Citigroup's provision of false marks.

B. Ridgeway II's Portfolio Was Not Rigorously and Independently Selected

78. Citigroup and CSAC's representations as to the careful, independent process that CSAC employed in the selection of Ridgeway II's collateral were false when made. In fact, CSAC's selection of Ridgeway II's assets was not conducted through an independent "credit-driven" process that sought to protect investors "against downside" but was rather driven by Citigroup's business needs to unload as many of its own deteriorating and unmarketable assets as possible and to create a hedge for its mortgage-backed securities exposures. Nor did CSAC seek "diversity" for Ridgeway II's portfolio but rather allowed and fostered a high concentration of assets from Citigroup's own warehouse, further demonstrating that CSAC had essentially abandoned the detailed multi-step asset selection process it had described to Ambac in order to allow Citigroup to utilize Ridgeway II as a dumping ground for its own deteriorated assets.

79. The manner in which Citigroup's deteriorated assets were given preference over more secure securities that could be obtained from third parties further rendered false CSAC's claim that it would "[c]ompare relative value versus other available credits" in making its investment decisions as well as the representations in the Offering Circular that Citigroup's own assets would only be selected for inclusion in the Ridgeway II portfolio if such purchases were "consistent with the investment guidelines and objectives of the Issuer," were at "fair market value" and were "otherwise on an 'arm's length basis.'"

80. Furthermore, CSAC's representations that it conducted an intensive asset-by-asset review of each credit, comparing it against the relative value of other assets available in the marketplace, was false in light of certain concealed facts (unbeknownst to Ambac) regarding the correlation between the Ridgeway II portfolio and the ABX indices. Typically, CDO portfolios selected on the basis of an independent comparative credit analysis — such as CSAC purported

to do for Ridgeway II — exhibited low correlations with the ABX indices, with many managed CDO portfolios exhibiting a correlation to the ABX indices of 10% or less. Furthermore, in the case of Ridgeway II, Citigroup had represented in the Offering Circular provided to Ambac that the “eligibility criteria” for the Ridgeway II portfolio prohibited the inclusion of any “Index Security,” further confirming that there would be no tracking between the Ridgeway II portfolio and any index.

81. However, CSAC’s and Citigroup’s representations with regard to the “eligibility criteria” requirements and the lack of correlation with an index were false. Even given the structural protections that Ambac believed were present in the transaction, including the represented level of subordination, Ambac specifically relied on the eligibility criteria. As Ambac only recently learned, there was a non-coincidental correlation between the Ridgeway II portfolio and the ABX indices that reflected CSAC and Citigroup having purposefully selected constituents of the ABX indices for inclusion in the portfolio. The correlation between the Ridgeway II portfolio and the ABX indices was not happenstance but was rather part of an undisclosed scheme by Citigroup to hijack a portion of the Ridgeway II portfolio to effect a hedge — indeed, Citigroup later admitted that during this time period it was already “anticipating ... a difficult environment” and had set about to “reduce our exposure.” The fact that CSAC allowed Citigroup to manipulate Ridgeway II’s portfolio to effect such a shorting strategy was also a complete abdication of CSAC’s obligations to select the comparatively best assets possible for the Ridgeway II portfolio and was patently inconsistent with the supposed “bottom up” review that CSAC touted it would use to select each and every asset.

82. CSAC participated in this fraudulent scheme because it desired the lucrative fees that it could continue to earn as Citigroup’s “go to” collateral manager. Since 2006 alone, CSAC

managed six Citigroup-structured CDO vehicles with over \$6 billion in notional value under management — representing about half of CSAC's overall collateral management business. Moreover, with respect to Ridgeway II, CSAC was dependent on Citigroup, who was acting as the warehousing facility provider, to fund the acquisition of any assets that CSAC selected for inclusion in the collateral portfolio. Swayed by the management fees it was earning from Citigroup, as well as by the returns that it shared with Citigroup on the collateral, CSAC acquired for Citigroup warehouse facilities, CSAC became less of the "independent" manager that its representations and reputation had led Ambac to believe than merely another instrumentality of Citigroup.

83. Citigroup and CSAC are equally responsible for each other's misrepresentations regarding the asset selection process as each misrepresentation was made with the other's knowledge in a context in which they knew and intended that the misrepresentations would be relied upon by Ambac, and neither Citigroup nor CSAC sought to correct them.

C. Ridgeway II Was Not Successfully Marketed to Third Parties

84. Contrary to Citigroup's representations to Ambac, the marketing of Ridgeway II's notes to third-party investors had gone exceedingly poorly, and Citigroup knew well before the transaction closed that it would find very few third-party investors for the subordinated notes that were issued by Ridgeway II. Citigroup nonetheless followed through on the Ridgeway II securitization for the overriding, yet undisclosed, purpose of offloading as much of the structure and associated risk as it could onto Ambac in order to thereby remove it from Citigroup's own books.

85. Yet, Citigroup would only be able to succeed in convincing Ambac to assume the massive amount of risk on the Ridgeway II transaction if it engaged in the charade of Citigroup

having found a receptive market among third party investors for Ridgeway II's subordinated notes. Thus, Citigroup orchestrated multiple expansions of the subordinated note issuances and its June 1, 2007 pricing of Ridgeway II to falsely convey to Ambac that there was market demand for the notes. Citigroup knew that Ambac would understand the structural modifications and the pricing of the notes to mean that Citigroup had obtained commitments to sell at least 80% of the offered Ridgeway II notes and that it would rely upon that purported fact in deciding to enter into the Ridgeway II Swaps. The reality, however, was that Citigroup had found hardly any third parties to invest in the subordinated notes issued by Ridgeway II and almost all of the investors it did find were, in fact, other Citigroup-structured CDOs whose portfolios Citigroup controlled in the same manner in which it exercised control over the Ridgeway II portfolio. Citigroup nonetheless pretended to have found a more receptive market than it had in order to obtain the credit protection from Ambac that Citigroup was so desperately seeking.

86. Even though this ruse involved Citigroup itself having to retain most of the \$1 billion of subordinated notes in the Ridgeway II structure, retaining those notes was essentially costless to Citigroup. Since Citibank N.A., through the synthetic collateral credit default swaps, held a short position on all of Ridgeway II's synthetic collateral, Citigroup stood to gain from any losses Ridgeway II incurred on synthetic collateral thereby benefiting from an inexpensive hedge provided by Ridgeway II. Moreover, since all of the assets were already on Citigroup's books, whatever small costs there were to Citigroup were both inevitable given its obligations under the warehousing facility should the deal have failed to close and were vastly outweighed by the benefit of both unloading nearly \$2 billion of risk onto Ambac and effecting a low-cost hedge through the use of the synthetic collateral.

D. Ridgeway II's Portfolio Was Not "High Grade"

87. Citigroup's claims as to the quality of the assets in Ridgeway II's portfolio were also materially false. Whereas Citigroup repeatedly touted the Ridgeway II portfolio as "high grade," it in fact knew that this description was misleading as to many of the assets in the portfolio — especially many of the CDO securities — that Citigroup knew faced a much higher risk of default than was associated with their purportedly high-grade credit ratings. This was especially true of the hundreds of millions of dollars of notes from prior Citigroup-created CDOs, which were essentially unmarketable detritus from Citigroup's CDO warehouse. To refer to such assets as "high grade" was both false and misleading.

88. Citigroup compounded these misrepresentations by repeatedly assuring Ambac that the collateral pool had a low overall risk of default associated with a WARF in the mid-60s. By listing the purported WARF in each term sheet, Citigroup intended Ambac to believe that the aggregate quality of the Ridgeway II collateral pool was high and the cumulative probability of default was low. By including the WARF in its term sheets, Citigroup represented to Ambac that the WARF was correct, was based on all material information, and was not changing over time. Yet at the time it made these representations, Citigroup knew that the value of the underlying assets was rapidly deteriorating and that defaults were far more likely than the WARF indicated.

E. Citigroup Falsely Represented That Ridgeway II Met the Credit Ratings Requirements

89. Citigroup's representations to Ambac that each of the tranches of notes issued by Ridgeway II — including the super-senior tranches that Ambac wrapped — met the stated credit rating requirements were also false and/or misleading. As Citigroup knew, the toxic assets that it had arranged to have dumped into Ridgeway II's collateral portfolio impaired Ridgeway II's credit profile to such an extent that the notes could not properly receive the credit ratings

required as a condition to their issuance. Citigroup knew that Ridgeway II's collateral portfolio had already suffered overall deterioration of more than 20% of its par value a month before closing, which equated to reasonably expected losses of over \$550 million. Losses of that magnitude would result in the total loss of principal for the holders of the Class A3 Notes, Class A4 Notes, Class A5 Notes, Class B Notes, and Class C Notes, and a partial loss of principal for holders of the Class A2 Notes, all of which had to receive high-grade ratings for Ridgeway II to come to market. In light of such anticipated losses, Citigroup knew that Ridgeway II's assets did not warrant high-grade ratings. Therefore, had Citigroup disclosed its knowledge regarding the impairment of the Ridgeway II portfolio to S&P, Moody's, and Fitch, the notes issued by Ridgeway II could not have received their requisite credit ratings and the transaction would not have closed.

90. Nonetheless, to insure that Ridgeway II would come to market, Citigroup either intentionally provided the ratings agencies with false information or withheld information that it knew was necessary for the ratings agencies to accurately rate the true credit quality of Ridgeway II's notes. Accordingly, Citigroup knew that the credit ratings it obtained from the ratings agencies for Ridgeway II's notes were inaccurate because the deterioration in the collateral portfolio made the likelihood of default much greater, and the likelihood of repayment far lower, than the ratings reflected. Citigroup's manipulation of the credit ratings rendered false and/or misleading its representations to Ambac that the issuance of the Ridgeway II notes would be conditioned upon those notes receiving the requisite high-grade credit ratings claimed by Citigroup.

E. Ambac did not have a true 35% subordination

91. Finally, in light of the other misrepresentations concerning the Ridgeway II transaction, it was also false for Citigroup to represent to Ambac that it had the protection of a 35% subordination against losses. In fact, even before the Swaps closed, the severe impairment in Ridgeway II's collateral had the effect of eroding more than half of the \$1 billion in subordination that Citigroup had assured Ambac would protect the super-senior notes from loss. Stripped of that subordination, the risk of loss on the super-senior notes, and thus the Swaps, was much greater than Citigroup had represented.

V. The Ridgeway II Swaps Close and Deteriorate

92. Relying on Citigroup's and CSAC's materially false representations and omissions, Ambac agreed to enter into the Swaps. The transaction was memorialized by an ISDA Master Agreement (with accompanying schedule) dated July 3, 2007, and four confirmations, each with an effective date of June 27, 2007. The Swaps referenced the Class A1A, A1B and A1C Floating Rate Notes due 2047, totaling \$1.95 billion of the \$3 billion Ridgeway II offering. Had Citigroup and CSAC not misrepresented the true facts, Ambac would never have agreed to enter into the Ridgeway II Swaps.

93. Since the close of the Ridgeway II transaction, the assets in Ridgeway II's collateral pool have deteriorated significantly, with the expectation that Ambac will be called upon to cover substantial anticipated losses. In fact, in November 2007, less than *five months* after Ridgeway II closed, Citigroup's CFO, Gary Crittenden, conceded publicly what Citigroup had known internally but hidden from Ambac for many months, that the super-senior positions in Citigroup's CDOs, such as Ridgeway II, were in trouble: "We have not seen a reduction in cash flow yet on the super-senior portfolios ... but I think everyone on our team believes that is going

to happen, that we are going to see that happen very likely, and ... there will be ratings reductions on these securities and we'll see some cash flow impairment." Citigroup's and CSAC's fraudulent inducement of Ambac to enter into the Swaps has had a direct, material, and foreseeable impact on Ambac and its CDS business. Ambac faces substantial anticipated losses in respect of the Swaps, has been forced to expend substantial resources in attempting to ameliorate the damage done by the looming threat of these anticipated losses and has already incurred actual losses in excess of \$2.7 million.

CAUSES OF ACTION

**FIRST CAUSE OF ACTION
AGAINST CITIGROUP
(Fraud)**

94. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

95. Citigroup made material misrepresentations of fact in connection with Ambac's participation in the Swaps. It misrepresented, among other things, that:

- a. the Ridgeway II portfolio was stable and performing well and had an average mark-to-market valuation as of May 31, 2007 equal to approximately 96% of the face value of the securities;
- b. Ridgeway II's assets were being carefully selected by an independent collateral manager through a "credit-intensive" investment approach that would "seek to protect against downside" and focus on "diversification of asset type, issuer and servicer";
- c. Ridgeway II was successfully marketed to third party investors;

- d. Ridgeway II's collateral portfolio was limited to "high grade" assets and had a WARF in the mid-60s;
- e. the issuance of Ridgeway II's notes would be conditioned upon them receiving specified "high grade" ratings based upon Citigroup's disclosure to S&P, Moody's and Fitch of material information regarding the credit quality of the securities in the portfolio; and,
- f. there would be \$1 billion of notes held by third-party investors subordinated to the positions referenced in the Swaps thus providing Ambac with a highly conservative 35% subordination.

96. Citigroup knew that its statements were false and misleading, or at a minimum was reckless in not knowing whether the statements were true when they were made. Citigroup made these representations with the intent and expectation that Ambac would rely on them.

97. Citigroup also had a duty of disclosure to Ambac. Citigroup structured Ridgeway II, underwrote many of the RMBS and CDO offerings comprising Ridgeway II's collateral portfolio, originated many of the mortgages backing these RMBS and CDO offerings and was thus uniquely aware of the true risks underlying the Swaps. Ambac did not have reasonable access to the same information to verify Citigroup's representations which, unbeknownst to Ambac at the time, were partial, ambiguous and incomplete. Citigroup's superior and unique knowledge of the essential facts rendered the Swaps inherently unfair without adequate disclosure.

98. In breach of this duty, Citigroup failed to disclose, among other things, that:
- a. its overriding purpose in creating Ridgeway II was to transfer substantial risk onto Ambac;

- b. as of May 31, 2007, the mark-to-market valuation of the collateral portfolio was less than 79% of its aggregate face amount, with the more than \$400 million of notes in the portfolio from prior Citigroup-structure CDOs having a mark-to-market valuation of less than 70% of their aggregate face amount;
- c. the collateral portfolio was comprised of deteriorating assets as well as the recycled detritus from the prior CDO and RMBS offerings that it had been unable to sell;
- d. a significant portion of the Ridgeway II collateral correlated to the ABX indices in violation of "eligibility criteria" prohibiting the purchase of Index Securities and had been selected for the sole purpose of creating a hedge for Citigroup;
- e. it had not successfully marketed Ridgeway II's subordinated notes to third-party investors;
- f. Citigroup had withheld material information regarding deterioration in the collateral portfolio from S&P, Moody's and Fitch that was necessary for them to provide accurate credit ratings for the notes issued by Ridgeway II; and
- g. as a result, the 35% subordination Citigroup had claimed would protect Ambac against losses did not exist.

99. Ambac reasonably relied on Citigroup's misrepresentations and omissions, without which Ambac would not have agreed to enter into the Swaps. Citigroup's conduct was willful, malicious, reckless and without regard to Ambac.

100. Accordingly, the Ridgeway II Swaps should be rescinded and the parties restored to the status quo ante. In the alternative, as a direct, proximate and foreseeable result of

Citigroup's conduct, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**SECOND CAUSE OF ACTION
AGAINST CITIGROUP
(Negligent Misrepresentation)**

101. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

102. Citigroup had a duty of disclosure to Ambac. Citigroup structured Ridgeway II, underwrote many of the RMBS and CDO issuances comprising Ridgeway II's collateral portfolio, originated many of the mortgages backing these RMBS and CDO issuances and was thus uniquely aware of the true risks underlying the Swaps. Ambac did not have reasonable access to the same information to verify Citigroup's representations which, unbeknownst to Ambac at the time, were partial, ambiguous and incomplete. Citigroup's superior and unique knowledge of the essential facts rendered the Swaps inherently unfair without adequate disclosure.

103. Citigroup made material misrepresentations of fact in connection with Ambac's participation in the Swaps that it was negligent in failing to know were false. It misrepresented, among other things, that:

- a. the Ridgeway II portfolio was stable and performing well and had an average mark-to-market valuation as of May 31, 2007 equal to approximately 96% of the face value of the securities;
- b. Ridgeway II's assets were being carefully selected by an independent collateral manager through a "credit-intensive" investment approach that would "seek to

protect against downside” and focus on “diversification of asset type, issuer and servicer”;

- c. Ridgeway II was successfully marketed to third party investors;
- d. Ridgeway II’s collateral portfolio was limited to “high grade” assets and had a WARF in the mid-60s;
- e. the issuance of Ridgeway II’s notes would be conditioned upon them receiving specified “high grade” ratings based upon Citigroup’s disclosure to S&P, Moody’s and Fitch of material information regarding the credit quality of the securities in the portfolio; and,
- f. there would be \$1 billion of notes held by third-party investors subordinated to the positions referenced in the Swaps thus providing Ambac with a highly conservative 35% subordination.

104. Citigroup was negligent in failing to disclose information that was material to Ambac’s participation the Swaps, including among other things, that:

- a. its overriding purpose in creating Ridgeway II was to transfer substantial risk onto Ambac;
- b. as of May 31, 2007, the mark-to-market valuation of the collateral portfolio was less than 79% of its aggregate face amount, with the more than \$400 million of notes in the portfolio from prior Citigroup-structure CDOs having a mark-to-market valuation of less than 70% of their aggregate face amount;
- c. the collateral portfolio was comprised of deteriorating assets as well as the recycled detritus from the prior CDO and RMBS offerings that it had been unable to sell;

- d. a significant portion of the Ridgeway II collateral correlated to the ABX indices in violation of "eligibility criteria" prohibiting the purchase of Index Securities and had been selected for the sole purpose of creating a hedge for Citigroup;
- e. it had not successfully marketed Ridgeway II's subordinated notes to third party investors;
- f. Citigroup had withheld material information regarding deterioration in the collateral portfolio from S&P, Moody's and Fitch that was necessary for them to provide accurate credit ratings for the notes issued by Ridgeway II; and
- g. as a result, the 35% subordination Citigroup had claimed would protect Ambac against losses did not exist.

105. Citigroup knew that Ambac would and did rely on the information that it provided in deciding whether to enter into the Swaps, and Citigroup made these statements for that purpose.

106. Ambac reasonably relied on Citigroup's misrepresentations and omissions, without which Ambac would not have agreed to enter into the Swaps.

107. Accordingly, the Ridgeway II Swaps should be rescinded and the parties restored to the status quo ante. In the alternative, as a direct, proximate and foreseeable result of Citigroup's conduct, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**THIRD CAUSE OF ACTION
AGAINST CSAC
(Fraud)**

108. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

109. CSAC made material misrepresentations of fact in connection with Ambac's participation in the Swaps. It misrepresented, among other things, that:

- a. it had selected and would continue to select the assets in Ridgeway II's collateral portfolio through a "credit-intensive" investment approach that would "seek to protect against downside" for Ridgeway II's investors and focus on "diversification of asset type, issuer and servicer";
- b. it had and would continue to engage in a "bottom-up" rigorous review of each asset's underlying collateral to "[e]xamine key collateral characteristics (e.g., FICO, LTV, IO's, MTA's, 2nd liens, etc.)" and "[s]crutinize detailed breakdown of collateral (e.g., by credit score, loan-to-value ratio, etc.)";
- c. no investment decision was made without CSAC "[c]ompar[ing] relative value versus other available credits," with the single most important factor that guided each investment decision being "Credit, credit, credit"; and
- d. the Ridgeway II portfolio was stable and performing well and had an average mark-to-market valuation as of May 31, 2007 equal to approximately 96% of the face value of the securities.

110. CSAC knew that its statements were false and misleading, or at a minimum was reckless in not knowing whether the statements were true when they were made. CSAC made these representations with the intent and expectation that Ambac would rely on them.

111. CSAC also had a duty of disclosure to Ambac. As collateral manager, CSAC had essential and unique knowledge and expertise that Ambac could not replicate, including intimate familiarity with the assets selected for the Ridgeway II portfolio and the process through which those assets were selected. Ambac did not have reasonable access to the same information to verify CSAC's representations which, unbeknownst to Ambac at the time, were partial, ambiguous and incomplete.

112. In breach of this duty, CSAC failed to disclose to Ambac, among other things, that:

- a. it did not "independently" select the assets for inclusion in Ridgeway II's asset portfolio, but rather that Citigroup's business interests were the central criteria in the selection process;
- b. the collateral portfolio was comprised of deteriorating assets as well as the recycled detritus from the prior CDO and RMBS offerings that Citigroup had been unable to sell;
- c. a significant portion of the Ridgeway II collateral correlated to the ABX indices in violation of "eligibility criteria" prohibiting the purchase of Index Securities and had been selected for the sole purpose of creating a hedge for Citigroup; and
- d. as of May 31, 2007, the mark-to-market valuation of the collateral portfolio was less than 79% of its aggregate face amount, with the more than \$400 million of notes in the portfolio from prior Citigroup-structure CDOs having a mark-to-market valuation of less than 70% of their aggregate face amount.

113. Ambac reasonably relied on CSAC's misrepresentations and omissions, without which Ambac would not have agreed to enter into the Swaps. CSAC's conduct was willful, malicious, reckless and without regard to Ambac.

114. As a direct, proximate and foreseeable result of CSAC's conduct, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**FOURTH CAUSE OF ACTION
AGAINST CSAC
(Negligent Misrepresentation)**

115. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

116. CSAC had a duty of disclosure to Ambac. As collateral manager, CSAC had essential and unique knowledge and expertise that Ambac could not replicate, including intimate familiarity with the assets selected for the Ridgeway II portfolio and the process through which those assets were selected. Ambac did not have reasonable access to the same information to verify CSAC's representations which, unbeknownst to CSAC at the time, were partial, ambiguous and incomplete.

117. CSAC made material misrepresentations of fact in connection with Ambac's participation in the Swaps that it was negligent in failing to know were false. It misrepresented, among other things, that:

- a. it had selected and would continue to select the assets in Ridgeway II's collateral portfolio through a "credit-intensive" investment approach that would "seek to protect against downside" for Ridgeway II's investors and focus on "diversification of asset type, issuer and servicer";

- b. it had and would continue to engage in a "bottom-up" rigorous review of each asset's underlying collateral to "[e]xamine key collateral characteristics (e.g., FICO, LTV, IO's, MTA's, 2nd liens, etc.)" and "[s]crutinize detailed breakdown of collateral (e.g., by credit score, loan-to-value ratio, etc.)";
- c. no investment decision was made without CSAC "[c]ompar[ing] relative value versus other available credits," with the single most important factor that guided each investment decision being "Credit, credit, credit"; and
- d. the Ridgeway II portfolio was stable and performing well and had an average mark-to-market valuation as of May 31, 2007 equal to approximately 96% of the face value of the securities.

118. CSAC was negligent in failing to disclose information that was material to Ambac's participation in the Swaps, including among other things, that:

- a. it did not "independently" select the assets for inclusion in Ridgeway II's asset portfolio, but rather that Citigroup's business interests were the central criteria in the selection process;
- b. the collateral portfolio was comprised of deteriorating assets as well as the recycled detritus from the prior CDO and RMBS offerings that Citigroup had been unable to sell;
- c. a significant portion of the Ridgeway II collateral correlated to the ABX indices in violation of "eligibility criteria" prohibiting the purchase of Index Securities and had been selected for the sole purpose of creating a hedge for Citigroup; and
- d. as of May 31, 2007, the mark-to-market valuation of the collateral portfolio was less than 79% of its aggregate face amount, with the more than \$400 million of

notes in the portfolio from prior Citigroup-structure CDOs having a mark-to-market valuation of less than 70% of their aggregate face amount.

119. CSAC knew that Ambac would and did rely on the information that it provided in deciding whether to enter into the Swaps, and CSAC made these statements for that purpose.

120. Ambac reasonably relied on CSAC's misrepresentations and omissions, without which Ambac would not have agreed to enter into the Swaps.

121. As a direct, proximate and foreseeable result of CSAC's conduct, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**FIFTH CAUSE OF ACTION
AGAINST CSAC
(Breach of Fiduciary Duty)**

122. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

123. CSAC's exercise of discretion as Ridgeway II's purportedly independent collateral manager gave rise to fiduciary duties obligating CSAC to put Ambac's interests ahead of its own. As collateral manager, CSAC selected the assets that were included in Ridgeway II's portfolio based, not only certain eligibility criteria contained in Ridgeway II's indenture, but on its experience, independent analysis and discretion.

124. CSAC's superior expertise and knowledge of the Ridgeway II portfolio also gave rise to fiduciary duties obligating CSAC to disclose material information to Ambac. As collateral manager, CSAC had essential and unique knowledge and expertise that Ambac could not replicate, including intimate familiarity with the assets selected for the Ridgeway II portfolio and the process through which those assets were selected. Ambac did not have reasonable access

to the same information to verify CSAC's representations which, unbeknownst to Ambac at the time, were partial, ambiguous and incomplete.

125. As a result of the discretion CSAC exercised over selecting Ridgeway II's assets and its superior expertise and knowledge of the portfolio, CSAC occupied a position of trust and influence, and Ambac reposed trust and confidence in CSAC.

126. CSAC breached its fiduciary duties to Ambac in multiple respects. It misrepresented, among other things, that:

- a. it had selected and would continue to select the assets in Ridgeway II's collateral portfolio through a "credit-intensive" investment approach that would "seek to protect against downside" for Ridgeway II's investors and focus on "diversification of asset type, issuer and servicer";
- b. it had and would continue to engage in a "bottom-up" rigorous review of each asset's underlying collateral to "[e]xamine key collateral characteristics (e.g., FICO, LTV, IO's, MTA's, 2nd liens, etc.)" and "[s]crutinize detailed breakdown of collateral (e.g., by credit score, loan-to-value ratio, etc.)";
- c. no investment decision was made without CSAC "[c]ompar[ing] relative value versus other available credits," with the single most important factor that guided each investment decision being "Credit, credit, credit"; and
- d. the Ridgeway II portfolio was stable and performing well and had an average mark-to-market valuation as of May 31, 2007 equal to approximately 96% of the face value of the securities.

127. Moreover, CSAC failed to disclose information that was material to Ambac's participation in the Swaps, including among other things, that:

- a. it did not “independently” select the assets for inclusion in Ridgeway II’s asset portfolio, but rather that Citigroup’s business interests were the central criteria in the selection process;
- b. the collateral portfolio was comprised of deteriorating assets as well as the recycled detritus from the prior CDO and RMBS offerings that Citigroup had been unable to sell;
- c. a significant portion of the Ridgeway II collateral correlated to the ABX indices in violation of “eligibility criteria” prohibiting the purchase of Index Securities and had been selected for the sole purpose of creating a hedge for Citigroup; and
- a. as of May 31, 2007, the mark-to-market valuation of the collateral portfolio was less than 79% of its aggregate face amount, with the more than \$400 million of notes in the portfolio from prior Citigroup-structure CDOs having a mark-to-market valuation of less than 70% of their aggregate face amount.

128. As a direct, proximate and foreseeable result of CSAC’s breaches of fiduciary duty, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**SIXTH CAUSE OF ACTION
AGAINST CSAC
(Aiding and Abetting Fraud)**

129. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

130. As described above, CSAC provided substantial assistance to advance the fraud described herein and asserted in the first cause of action.

131. Because of its position as collateral manager for the Ridgeway II CDO, its superior knowledge of the true quality and value of the collateral pool, and its superior knowledge of an expertise concerning the actual risk of default of the assets in the pool, CSAC had knowledge of the fraud described herein and intentionally assisted in its commission.

132. CSAC is liable to Ambac for the damages caused by its unlawful conduct in an amount to proven at trial. Ambac is also entitled to punitive damages.

**SEVENTH CAUSE OF ACTION
AGAINST CITIGROUP
(Aiding and Abetting Fraud)**

133. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

134. As described above, Citigroup provided substantial assistance to advance the fraud described herein and asserted in the third cause of action.

135. Citigroup had knowledge of the fraud described herein and intentionally assisted in its commission.

136. Accordingly, the Ridgeway II Swaps should be rescinded and the parties restored to the status quo ante. In the alternative, as a direct, proximate and foreseeable result of Citigroup's conduct, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**EIGHTH CAUSE OF ACTION
AGAINST CITIGROUP
(Aiding and Abetting Breach of Fiduciary Duty)**

137. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

138. As described above, Citigroup had actual knowledge that:

- a. CSAC did not “independently” select the assets for inclusion in Ridgeway II’s asset portfolio, but rather that Citigroup’s business interests were the central criteria in CSAC’s selection process;
- b. the assets that CSAC had selected for inclusion in the collateral portfolio were largely the deteriorating assets and the recycled detritus from the prior CDO and RMBS offerings that Citigroup had been unable to sell;
- c. in assembling Ridgeway II’s portfolio CSAC had tracked the ABX indices in order to provide Citigroup with a hedge; and
- d. as of May 31, 2007, the mark-to-market valuation of the collateral portfolio was less than 79% of its aggregate face amount, with the more than \$400 million of notes in the portfolio from prior Citigroup-structure CDOs having a mark-to-market valuation of less than 70% of their aggregate face amount.

139. As described above, Citigroup knowingly and substantially assisted in CSAC’s breaches of its fiduciary duty to Ambac.

140. Accordingly, the Ridgeway II Swaps should be rescinded and the parties restored to the status quo ante. In the alternative, as a direct, proximate and foreseeable result of Citigroup’s conduct, Ambac has been damaged in an amount to be determined at trial. Ambac is also entitled to punitive damages.

**NINTH CAUSE OF ACTION
AGAINST CGML
(Rescission of Contract Due to Fraud)**

141. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

142. As a result of the material misrepresentations and omissions described above, Ambac is entitled to a judgment rescinding the Ridgeway II Swaps.

**TENTH CAUSE OF ACTION
AGAINST CGML
(Rescission of Contract Due to Unilateral Mistake)**

143. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

144. Ambac entered into the Ridgeway II Swaps based on the following material mistakes of fact:

- a. the Ridgeway II portfolio was stable and performing well and had an average mark-to-market valuation as of May 31, 2007 equal to approximately 96% of the face value of the securities;
- b. Ridgeway II's assets were being carefully selected by an independent collateral manager through a "credit-intensive" investment approach that would "seek to protect against downside" and focus on "diversification of asset type, issuer and servicer";
- c. Ridgeway II was successfully marketed to third party investors;
- d. Ridgeway II's collateral portfolio was limited to "high grade" assets and had a WARF in the mid-60s;

- e. the issuance of Ridgeway II's notes would be conditioned upon them receiving specified "high grade" ratings based upon Citigroup's disclosure to S&P, Moody's and Fitch of material information regarding the credit quality of the securities in the portfolio; and,
- f. there would be \$1 billion of notes held by third-party investors subordinated to the positions referenced in the Swaps thus providing Ambac with a highly conservative 35% subordination.

145. Prior to entering into the Swaps, Ambac performed reasonable due diligence concerning the Swaps, the collateral pool, and the collateral manager.

146. Ambac's exercise of ordinary care reasonable under the circumstances did not reveal, and could not have revealed, the above material mistakes.

147. In light of CGML's knowledge that the above facts were not true, enforcement of the Swaps would be unconscionable and would unjustly enrich CGML.

148. Accordingly, Ambac is entitled to rescission of the Swaps.

**ELEVENTH CAUSE OF ACTION
AGAINST CITIGROUP
(Fraudulent Conveyance Pursuant to N.Y. Debt. & Cred. Law § 273)**

149. Ambac repeats and realleges the foregoing allegations as though they were fully set forth here.

150. Under N.Y. Debt. & Cred. Law § 270, Ambac is a "creditor" of Ridgeway II.

151. Citigroup arranged for Ridgeway II to pay at or near the face price for all of the assets comprising the collateral portfolio. Citigroup did so despite being aware of the fact that the market value of the assets was severely impaired at the time. As a result, Ridgeway II's collateral was worth far less than the amount it paid Citigroup for it.

152. Citigroup did not convey these assets to Ridgeway II in good faith.

153. As a result of these fraudulent transfers, Ridgeway II was rendered insolvent as its liabilities exceeded its assets.

154. At the time of the transfer, as a result of Citigroup's conduct, Ambac was unaware of the actual value of the collateral. Ambac was also unaware that the transfer would render Ridgeway II insolvent.

155. Accordingly, Citigroup's conveyance to Ridgeway II of the assets comprising its collateral portfolio at its inception should be avoided.

Prayer for Relief


WHEREFORE, Ambac requests the Court enter judgment:

- (a) rescinding the Ridgeway II Swaps;
- (b) in the alternative, avoiding Citigroup's conveyance to Ridgeway II of assets comprising its collateral portfolio at inception;
- (c) in the alternative, awarding Ambac compensatory and punitive damages in amounts to be determined at trial, together with pre-judgment interest at the maximum rate allowable by law;
- (d) awarding Ambac reasonable costs and expenses incurred in this action, including, to the extent applicable, counsel fees; and
- (e) such other relief as the Court deems just and proper.

Dated: New York, New York
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