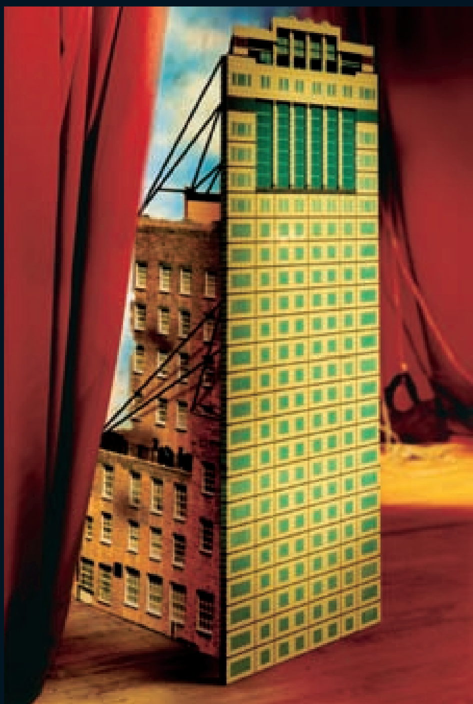
BILL ACKMAN, THE BOND INSURERS, AND THE MOST CONTENTIOUS BATTLE OF THE CREDIT CRISIS

CONFIDENCE GAME

HOW A HEDGE FUND MANAGER CALLED WALL STREET'S BLUFF



CHRISTINE S. RICHARD

BLOOMBERG NEWS

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by Christine S. Richard

Bloomberg News

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For Dean

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Preface

For nearly 10 years, I covered the bond market as a Wall Street reporter, first at Dow Jones and later for Bloomberg News. It was a period of enormous growth and innovation in the credit markets. As the expansion peaked, Wall Street manufactured billions of dollars of debt every day, astonishing amounts of it considered triple-A or virtually risk-free. For a while, this was accomplished with true financial innovation. Later, the process was corrupted by delusion and dishonesty.

Of all the stories I covered, there was one that never seemed to go away: the battle between a company called MBIA and a hedge fund manager named Bill Ackman, who was obsessed with that company's practices.

What is MBIA? It stands for Municipal Bond Insurance Association. For years it was the largest of a handful of extraordinarily profitable companies that together guaranteed more than $2 trillion of debt issued by entities ranging from the Cincinnati school system to a shell company in the Cayman Islands. Insurance transformed lower-rated bonds into triple-A-rated securities. Business boomed, giving MBIA some of the highest reported profit margins of any publicly traded company in the United States—even higher than Google and Microsoft.

If there was something about this business that was too good to be true, few people had any reason to point it out. Then in late 2002, Ackman, who ran a hedge fund called Gotham Partners, issued a research report titled *Is MBIA Triple-A?* in which he questioned just about every aspect of MBIA's business. Before he made his views public, Ackman bet against the company by purchasing derivative contracts called credit-default swaps, which would make his fund billions of dollars if MBIA filed for bankruptcy.

Ackman's research report was the opening shot in what became a long and bitter Wall Street feud between him and MBIA. From the start, MBIA was determined to silence Ackman's criticism, and he was no less determined to see MBIA leveled. Ackman was investigated at MBIA's urging by Eliot Spitzer, then New York's attorney general, and the Securities and Exchange Commission (SEC) followed suit.

For more than five years, the hedge fund manager questioned nearly every aspect of MBIA's business, bringing his research to the attention of rating companies, regulators, reporters, and investors. He cornered the chief executive officer (CEO) of PriceWaterhouseCoopers, MBIA's auditors, at a charity function, broached the issue with a bullish equity analyst at a funeral, and wrote to board members of Moody's Investors Service, warning them they could be held personally liable for inaccurate ratings. Eventually, Ackman turned the tables on MBIA, getting regulators to probe MBIA's business practices.

Big names have dominated the headlines during the credit crisis. Bear Stearns was the first major financial institution to collapse. American International Group required a $180 billion government rescue, a larger commitment in inflation-adjusted dollars than the Marshall Plan that rebuilt Europe after World War II. Lehman Brothers was the financial failure felt around the world.

Before all of this happened, another crisis played out. Little known outside of Wall Street, MBIA made hundreds of millions of dollars a year selling its triple-A credit rating. At the same time, it boasted to analysts and investors that it insured bonds on which it saw no chance of loss.

In the lobby of MBIA's headquarters in Armonk, New York, visitors were greeted by a large photo of sunlight pouring through trees. The image is one you might expect to see on an inspirational greeting card—the sunlight, a symbol of some higher power. "We help our clients achieve their financial goals by providing AAA credit protection," read the message alongside the photo. The sanctity of MBIA and the permanence of its triple-A credit rating were articles of faith on Wall Street.

Brash, blunt, almost neurotically persistent, Ackman was the perfect foil to the bond insurance business. Even among his friends and colleagues, Ackman is known for being a font of not-always-welcome forthrightness. He will tell people straight out that their hairstyle is unflattering or they ought to consult with his nutritionist about losing some weight. Ask him about his candor, and he says he gives people honest advice and that's a rare thing in this world.

The first time I spoke with Ackman was December 9, 2002, the day he issued his report on MBIA. "The more I looked, the more I found," he told me, and he just kept finding more. We spoke about MBIA and bond insurance on and off for more than five years.

Persistence had its price. Eventually, nearly every analyst who covered the company refused to take my calls. But MBIA was intriguing. I found the line that summed up the intrigue and contradiction of MBIA in a presentation Ackman made to Moody's Investors Service: "Management integrity has been compromised to uphold the 'no-loss' illusion." Someday, I thought, this conflict over a triple-A-rated company that was not as safe as it appeared would make a great story, one that might prove bigger than Ackman and MBIA.

How was it that MBIA could write insurance on hundreds of billions of dollars of debt and yet tell its investors that it guaranteed only bonds on which it expected to pay no claims? In an article for *Bloomberg Markets* magazine called "The Insurance Charade," Darrell Preston and I exposed part of the secret by looking into various public projects that weren't supposed to be obligations of the taxpayer. Yet when the insured bonds issued to finance these projects threatened to default, taxpayers were called on to cover the losses. MBIA had a nearly perfect track record in the municipal bond market because it wasn't the real insurer of the debt: Taxpayers were.

So what would eventually shatter this no-loss illusion? Bond insurers expanded into the structured finance market, the epicenter of Wall Street innovation. In this market, where all types of loans and securities were bundled into new securities, the game was not rigged in MBIA's favor.

In writing *Confidence Game*, I was able to draw from a wealth of source material that is contemporaneous with the events described in the book. Ackman gave me a CD-ROM containing every e-mail he had written or received that mentioned MBIA as well as years of appointment calendars and access to an office filled with more than 40 boxes of documents he'd collected in researching MBIA. He encouraged colleagues, advisers, and friends to talk with me and spent hours answering my questions. Ackman waived attorney-client privilege with Aaron Marcu, the attorney who represented him in the New York attorney general's investigation of Gotham Partners, so that Marcu could speak with me. Under several Freedom of Information requests, I obtained thousands of pages of testimony taken during Spitzer's and the SEC's probe of Gotham. (I have made several of the full transcripts available at confidencegame.net)

MBIA ultimately decided not to comment for the book or respond to any questions. For the most part, the views of MBIA management, as well as credit-rating company analysts, sell-side analysts, regulators, and MBIA investors, are represented through their public statements. Eric Dinallo, the New York state insurance superintendent who spoke with me about his efforts to stabilize the bond insurers beginning in 2007, was a helpful contributor to the book.

When Ackman bet against MBIA in the summer of 2002, bond insurance and triple-A ratings were unquestioned because they had to be above reproach. Too much depended on the ratings being right. By 2008, MBIA CEO Jay Brown acknowledged that somehow the bond insurer had become "the lynchpin supporting the global financial system."

"Bond insurance was almost like a religious institution in a kingdom that was totally inscrutable," said Richard Blumenthal, Connecticut's attorney general, who launched an investigation of credit ratings and bond insurance in 2008. This was a land in which financial sector debt—at $17 trillion—had grown from about 15 percent of gross domestic product in 1976 to 120 percent in 2008. This explosion of debt transformed Wall Street into a place of extraordinary wealth, where even those far down in the ranks came to expect multimillion-dollar bonuses. Almost no one on Wall Street wanted the music to stop.

Of course, Ackman took on this sacred institution knowing that he stood to make his investors billions of dollars if he was right. That was reason enough for many to view him as a villain. It turns out that Ackman had more than a bearish position on MBIA. He had a stake in the system being wrong. That makes his story an extraordinary vantage point from which to view the approaching credit crisis. As a result, he did something that few people were willing to do as irrationality continued to build in the credit markets: He raised questions and demanded answers in a era when too many people were silent.

So the story begins with the title of Ackman's controversial 2002 research report and a question that many people found impudent and even dangerous: "Is MBIA Triple-A?"

CHRISTINE S. RICHARD
March 2010

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THIS BOOK WOULD not have been possible without the support of Bloomberg News's editor-in-chief, Matthew Winkler. Every good story is about conflict, Matt tells reporters. I hope this one doesn't disappoint.

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Emma Moody, my editor at Bloomberg News during long days covering the bond insurance crisis, was a rock of composure and good spirits. Bob Burgess and Jonathan Neumann helped shepherd two award-winning stories on the bond insurers through the editing process. The late Fred Weigold edited a *Bloomberg Markets* article on the collapse of the bond insurers. His broad smile and booming laugh were a constant reminder that reporting can be the best job in the world. Mark Pittman, a Bloomberg reporter who was battling to make the Federal Reserve more accountable when he died in late 2009, proved to me that reporting can be the most important job in the world.

Bill Ackman's openness and optimism are key ingredients of this book, and I am grateful to him for sharing both with me over the last few years. He gave me a story to tell amidst all the financial gloom and doom that is in many ways about the importance of free speech, persistence, and staying positive.

Many thanks also are due to the people who agreed to be interviewed for the book, especially those who participated against their better judgment. Roy Katzovicz, Pershing Square's chief legal officer (and an excellent storyteller), is just one who springs to mind. Joelle Dellis and Bethany Norvell at Pershing Square cheerfully fielded numerous requests to track down documents.

Of the many helpful sources I called on in my reporting on the bond insurers, three stand out for their patience and willingness to share their insights: Ed Grebeck, Dick Larkin, and Matt Fabian.

One of the privileges of being a reporter is to learn from other people every day. Doug Noland, who warned about the problems in the credit markets for more than a decade as an analyst at David W. Tice & Assoc., convinced me that debt was the great, unrecognized story in America. Glenda Busick and Carol Hayes, two women in Brevard County, Florida who took on the formidable combination of Wall Street and the "good old boys" of local government, were an inspiration. Glenda's book on her experiences, which she wrote and published on her own time and at her own expense, is a testament to the hard work required of citizens in a democracy.

Finally, thanks to my family. My daughter, Sophie, encouraged me countless times with words, notes, and drawings when it felt like I'd taken on an impossible task. My greatest debt is to my husband, Dean Richard, who has cheered me on since I was twenty years old, and without whom nothing would be possible.

Chapter One 1

The Meeting

In our minds, our franchise is the ultimate money-back guarantee, the "Good Housekeeping Seal of Approval."

—GARY DUNTON, PRESIDENT OF MBIA, 2001

AS THE TAXI PULLED AWAY from Grand Central Station on a late November afternoon in 2002, Bill Ackman was bracing for a fight. The 36-year-old cofounder of a hedge fund called Gotham Partners had been summoned to a meeting with Jay Brown, the chief executive officer of MBIA Inc. MBIA's general counsel wouldn't say what Brown wanted to discuss, but Ackman had a suspicion. Gotham had placed a bet against the company that could make the fund $2 billion if MBIA filed for bankruptcy. The hedge fund planned to issue a critical research report questioning the bond insurer's triple-A rating.

Ackman had already described the situation in an October 2002 letter to his investors. "Our newest and largest [short] investment is on an extremely highly levered, yet triple-A-rated financial institution, which we believe has inadequate reserves, undisclosed credit-quality problems, aggressive accounting, and substantial unconsolidated indebtedness contained in off-balance-sheet special-purpose vehicles," he wrote. Ackman explained that the position had the potential to generate a return of approximately five times the fund's total assets if it was successful.

Though little known outside of Wall Street circles in 2002, MBIA ranked as one of the top five financial institutions in the country, as measured by outstanding credit exposure, along with Citigroup, Bank of America, and government-sponsored mortgage lenders Fannie Mae and Freddie Mac. Using its triple-A credit rating, MBIA had turned nearly half a trillion dollars of securities into investments that rating companies apparently considered as safe as U.S. Treasuries. Bonds issued by a water and sewer authority in Mississippi, debt backed by loans on used cars to people with a history of not paying their bills, and complex pools of derivatives held by a shell company in the Cayman Islands all became top-rated securities under the Midas touch of an MBIA guarantee.

Moody's Investors Service, Standard & Poor's, and Fitch Ratings—the credit-rating oligopoly—all assigned MBIA's bond-insurance unit a triple-A rating. Using computer models and historical default data, analysts at the rating companies had determined that MBIA could weather another Great Depression and still meet all of its claims.

Ackman was not convinced.

MBIA held just $1 of capital for every $140 of debt it guaranteed. Although the company claimed it underwrote risk to a so-called "zero-loss" standard, its past performance hadn't been free from error. The high leverage meant MBIA had virtually no margin of safety. The company's underwriting, transparency, accounting, and track record all had to be beyond reproach. Ackman, a money manager known for his intensive research, thought he saw problems with every one of these issues.

Earlier that day, Ackman had met for lunch with Michael Ovitz, the founder of Hollywood's Creative Artists Agency and a longtime investor in Ackman's fund. As they worked their way through six different versions of toro, the Japanese fatty tuna delicacy, Ackman asked Ovitz's advice about the upcoming meeting with Brown.

"It sounds like a very Japanese meeting," said Ovitz. In other words, he said, "Just shut up and listen."

ACKMAN'S TAXI STOPPED on Third Avenue outside the building where MBIA's attorneys, Debevoise & Plimpton, have their offices. Together with Gotham's general counsel, David Klafter, and one of the firm's analysts, Greg Lyss, Ackman headed for the security desk in the lobby. The group was sent upstairs, where Ackman told the receptionist they were there for the meeting with Jay Brown. She pointed Ackman toward a closed conference room door just behind the reception desk. Opening it, he found Brown seated at a conference table with a dozen other men. The conversation in the room came to an abrupt halt. "Hi," he said. "I'm Bill Ackman. I'm here to . . ."

"Wrong meeting," one of the men said as he jumped up to close the door. Ackman returned to the reception area, convinced he'd just interrupted a tired and frazzled-looking Brown in a meeting with his crisis-management team. The Gotham group was shown to another conference room and told to wait.

ACKMAN COFOUNDED Gotham Partners in 1993 with David Berkowitz, increasing the hedge fund's assets from $3 million to more than $350 million by 2001. The firm was small, with just nine employees. Ackman and the fund's analysts sought out companies with securities that were mispriced or misunderstood by the market. In MBIA's case, the market believed in the permanence of the company's triple-A rating. If it didn't, then the bond insurer's ability to write new business would have disappeared overnight.

Ackman had placed his bet against MBIA principally in the credit-default-swap market. Credit-default swaps, or CDS contracts, are derivatives that allow parties to buy and sell protection against a default on a security. The contracts are essentially life insurance policies on companies. The protection buyer—in Wall Street parlance—makes regular payments over the life of the contract to the protection seller, who promises to make a lump sum payment to the insurance buyer if a security defaults. The cost of the insurance rises and falls minute by minute based on the market's perception of the company's credit quality. Default protection on a company with a triple-A rating, which MBIA had in 2002, could be purchased cheaply because the risk of default was perceived to be de minimus.

Blythe Masters, a 26-year-old Trinity College graduate working at JPMorgan in 1995, is often credited with having invented CDS contracts. The contracts were created as a way for commercial banks to reduce their exposure to corporate borrowers. By purchasing protection against a default, the bank took on a position that would offset losses if a borrower defaulted.

The market for CDS contracts, which didn't exist before the mid-1990s, totaled $2.2 trillion by the end of 2002. Outstanding contracts hit $62 trillion by the end of 2007. Ackman was not seeking protection against MBIA filing for bankruptcy; he was betting that the chance of the company defaulting on its bonds was more likely than the market believed. In addition to shorting tens of millions of dollars of MBIA stock, Ackman bought protection against a default on $2 billion worth of MBIA debt. He had also set up two additional funds, Gotham Credit Partners I and IA, to hold CDS contracts on MBIA. Investors in these funds could earn nearly 40 times their money, or a 4,000 percent return, if MBIA filed for bankruptcy. Of course, investors would lose their entire investment if perceptions about MBIA's triple-A rating remained unchanged and unchallenged.

Ackman's bet was spectacularly contrarian. He was wagering on the collapse of a company that the rating companies had awarded their highest triple-A rating and that everyone else was counting on.

Indeed, MBIA's reason for being was to take the worries out of the debt market. MBIA's president, Gary Dunton, summed it up in the company's 2001 annual report: "In our minds, our franchise is the ultimate money-back guarantee, the 'Good Housekeeping Seal of Approval.'"

The company was started in the early 1970s by a young man named Jack Butler, who had worked on Wall Street for Franklin National Bank, picking municipal bonds for the bank's portfolio. One winter afternoon in 1967, as Butler was driving back from a ski weekend in Vermont with Jim Lopp, an investment banker, the pair hit on an idea: If you took the time to understand how the municipal bond market really worked, you could find plenty of municipal bonds on which the risk of default was practically zero. Butler bought such bonds all the time. Selling insurance on bonds that would never default sounded like a good business.

Butler and Lopp had worked together on a deal in Omaha, Nebraska, several years earlier that became their blueprint. The mayor of Omaha wanted to raise millions of dollars to build a sewage-incineration plant. The process was experimental, however, and taxpayers didn't want to foot the bill if the project didn't work. The sewage-incineration plan was designed to blast the sewage into a solid substance, which could then provide fuel to blast the next batch of sewage into more fuel. To finance the plan, the mayor, Lopp, and Butler came to an agreement. Lopp would underwrite the bonds, Butler would buy them, and the mayor would see to it that the project was bailed out if something went wrong.

In fact, the plant didn't work. As Butler remembers it, the headline in the local Omaha newspaper read "Ten Million Dollar Toilet Doesn't Flush." But the mayor made good on his promise, and the taxpayers bailed out the bondholders.

The municipal bond market was less risky than it appeared, Butler realized. The credit ratings on many municipal bonds didn't take into account the understanding between investors and public officials, such as Omaha's mayor, that bonds used to fund public projects wouldn't default.

Then came the spark of inspiration. If a smart investor could find bonds that were safer than they appeared, an even more astute businessperson could create a business guaranteeing these bonds. The bond-insurance business was simple: In exchange for receiving an upfront insurance premium, the bond insurer agreed to cover all interest and principal payments over the life of the bond if the issuer defaulted. As long as the bond insurer maintained its triple-A rating, the bonds remained triple-A. The beauty of bond insurance, Butler saw, was that the bond insurer didn't need capital to buy the bonds. The bond investor put up the capital. The insurer would collect the insurance premium up front in exchange for guaranteeing the bonds and would invest the premiums over the long term.

That's not to say bond insurance required no capital. To enter the business, Butler had to prove to regulators that the company had the wherewithal to make good on its guarantees. That meant setting aside some fraction of the amount of each bond it guaranteed. But how much? To determine the amount, Butler hired George Hempel, an economist who had studied municipal bond defaults during the Great Depression. With Hempel's help, Butler figured out how much capital a municipal bond–insurance company would have needed to weather the Depression. Although a large number of municipalities missed bond payments at the height of the Depression, most paid bondholders back, with interest, after just a few years. That meant a bond insurer didn't really need to pay claims so much as advance money for brief periods during times of extreme financial distress.

Still, it was a business that required extreme caution. "It has to be underwritten to a no-loss standard, otherwise the leverage is deadly," says Butler.

Butler and Lopp toyed with other business ideas, including manufacturing hollow golf balls. In the end, they went with municipal bond insurance. Bulter founded MBIA. Lopp, who died at age 51 of a heart attack on the tennis court of his vacation home in the south of France, started up Financial Security Assurance, another bond insurer.

FIFTEEN MINUTES AFTER Ackman and the others from Gotham were shown to the conference room, Brown appeared with MBIA's general counsel, Ram Wertheim, whose first question to the Gotham group was whether it planned to record the meeting. Ackman told him no, then asked Wertheim whether he and Brown planned on making a recording. They did not, Wertheim said.

Brown wasted no time getting to the point. He had been in the insurance industry for years, and no one had ever questioned his reputation, Ackman remembers Brown saying, "No one has ever gone to my regulators without my permission."

Ackman asked Brown whether he disputed any of the assertions Ackman had made about MBIA. Brown was aware of the issues in Ackman's report from questions he had received from a Wall Street equity analyst with whom Ackman had shared his findings.

"This isn't about the facts; it's about process," Ackman recalls Brown saying. "You're a young guy, early in your career. You should think long and hard before issuing the report. We are the largest guarantor of New York state and New York City bonds. In fact, we're the largest guarantor of municipal debt in the country. Let's put it this way: We have friends in high places."

In a follow-up letter to Ackman after the meeting, Wertheim reminded Gotham what was at stake: "MBIA is a regulated insurance company that operates in a regulated environment and acts in a fiduciary capacity for the benefit of our many constituencies—principally our policyholders, our customers, including the numerous states and municipalities that rely on bond insurance, and our stockholders but also our employees, our community, and the other people who rely on the vitality of the markets that we support. . . . MBIA's credibility and reputation in the market, and its triple-A ratings, are critical to our continued ability to service these constituencies."

In the meeting, Brown compared Gotham to Enron, which had been accused of manipulating California's electricity market. Was Gotham seeking to manipulate perceptions about a regulated insurance company by taking positions in the unregulated CDS market? Brown also asked Ackman how long Gotham planned to hold its CDS position on MBIA.

Ackman explained that for the hedge fund to make money on its CDS position, it was going to have to be correct in its criticism of MBIA. Ackman told Brown that the CDS market was not liquid enough for Gotham to easily trade in and out of such a huge position.

Wertheim asked to see a copy of Gotham's report before it was published so MBIA could check Gotham's facts. Ackman countered that it was considered inappropriate for analysts to give advance copies of research reports to companies but again offered to discuss any findings at the meeting.

The meeting ended abruptly. As the men filed out of the room, Ackman reached out to shake Brown's hand. "I don't think so," Brown said, refusing to extend his hand.

When Ackman, Klafter, and Lyss stepped back out onto Third Avenue, Ackman's first call was to Aaron Marcu, a lawyer with Covington & Burling, who had been advising Gotham on its research. "We left the meeting thinking we were going to be sued," Ackman told me years later.

Ackman's second call was to Paul Hilal, an investor in one of the Gotham Credit Partners funds and Ackman's friend since the two were undergraduate roommates at Harvard in the late 1980s. Ackman related the high points of the brief meeting: Brown's refusal to discuss Gotham's report, the apparent paranoia about whether Gotham was recording the conversation, the warning, the refusal to shake hands. Years later, Brown told the *Wall Street Journal* that he remembered refusing to shake Ackman's hand, though he recalled saying nothing that should have been interpreted as a threat.

Hilal had been hearing about MBIA for months. He and his girlfriend had spent a week with Ackman and his wife, Karen, at a beach house the Ackmans rented in Watch Hill, Rhode Island, during the summer of 2002. "Bill did what he always does on vacation," Hilal says. He read financial statements. That week his reading consisted of years of MBIA quarterly filings. "Every once in a while, you'd hear Bill exclaim, 'Oh, my God, this is such bullshit,'" Hilal recalls. "What he was reading about was another layer of hidden leverage or messed up accounting at MBIA. The tone was a combination of surprise but also glee: 'I can't believe it's this good.'"

Chapter Two 2

The Short Seller

A closed mouth gathers no foot.

—Bill Ackman's high school yearbook epithet, 1984

Bill Ackman's interest in MBIA started with an interest in triple-A ratings. Earlier in 2002, he'd made a substantial sum by shorting the stock and purchasing credit-default swaps on a company called the Federal Agricultural Mortgage Corporation, better known as Farmer Mac. The company was chartered by the U.S. government to create a secondary market for farm loans, and this government connection caused investors to view Farmer Mac as a triple-A-rated company. In fact, the company never sought to obtain a credit rating because the market perceived it to be triple-A and its bonds traded like other top-rated agency bonds at very tight spreads to Treasuries.

Ackman had originally gotten the idea of looking into Farmer Mac from Whitney Tilson, who heads up the hedge fund T2 Partners and who had been friends with Ackman since they were undergraduates at Harvard in the 1980s. Tilson suggested Ackman consider buying shares in the company. When Ackman reviewed the company's financial statements and later met with the company's chief executive officer

(CEO), he decided to short it instead. Before Ackman's involvement, Farmer Mac was rarely mentioned outside of trade publications such as *Progressive Farmer* and *Pork Magazine.* Ackman's research landed the company on the front page of the *New York Times* business section after he spoke with reporter Alison Leigh Cowan about his findings. Ackman churned out a series of reports on the company provocatively titled "Buying the Farm," Parts I, II, and III. He didn't mince words: "Gotham believes that the company is in precarious financial condition and could face severe financial stress."

For months, Ackman was a thorn in Farmer Mac's side. During one of the company's investor conference calls, Farmer Mac executives explained that their reason for not obtaining a credit rating was that the company did not want to pay the cost. In response, Ackman offered to pay for Farmer Mac's rating. His offer was rebuffed.

After Ackman issued his first report on the company, Farmer Mac's shares plummeted and premiums on its credit-default-swap (CDS) contracts jumped. Then the Senate Agricultural Committee asked the U.S. Government Accountability Office to look into the issues raised in the reports. The company responded by accusing Ackman and the *Times* of orchestrating a negative campaign to drive down its shares and asking the Securities and Exchange Commission (SEC) to investigate the *Times* reporter, Alison Leigh Cowan.

In July 2003, after MBIA prompted the New York attorney general's office to investigate Gotham Partners, Tilson was called to testify about Ackman's research efforts and, in particular, about his use of the press to spread his message. "Bill spent a number of hours walking [the *New York Times* reporter] through Farmer Mac's filings, the 10-K and 10-Q documents going back many years," Tilson said about one marathon meeting with Cowan, which he also attended. Ackman spent hours showing the reporter "problems, things that he believed the company was trying to hide." Investigators asked Tilson how long the meeting lasted. "Eight, maybe twelve hours," he replied.

Ackman's fund netted about $80 million on its Farmer Mac position. Shortly after his Farmer Mac win in the spring of 2002, Ackman asked Michael Neumann, a salesman on Lehman Brothers' credit desk who had sold him the contracts on Farmer Mac, if he could think of another triple-A-rated company that might not merit its lofty rating. Neumann told Ackman he was skeptical of the bond insurers. The largest bond insurer was MBIA Inc.

Ackman called MBIA and requested the previous five years of annual reports. Later, when he began to read Jay Brown's letter to shareholders in MBIA's 2001 annual report, it didn't take long for him to spot the first red flag. In the letter, Brown addressed the issue of so-called special-purpose vehicles (SPVs), which are created by companies to finance assets off of their balance sheets. The SPV purchases assets such as mortgages from a sponsor or parent company and sells debt to finance the purchase. The SPV is considered legally separate from the company that created it and is considered "bankruptcy remote," meaning that if the parent company filed for bankruptcy, the SPV would be unlikely to be dragged into the parent company's bankruptcy. Investors began to raise questions about the use of SPVs after Enron Corporation's off-balance-sheet debt contributed to its collapse because the risk had not actually been transferred.

"During the past several months, there has been a fair amount of public debate on issues such as balance-sheet transparency, special-purpose vehicles, risk management, accounting conflicts, and quality of earnings," Brown wrote in MBIA's annual report. "As you might expect, we have spent some time staring in the mirror." The result of this reflection, Brown told shareholders, was that investors would find expanded disclosure on the company's approximately $8 billion of special-purpose vehicles in that year's 10-K.

Ackman searched MBIA's public filings and found no previous mention of the SPVs to which Brown had alluded. The apparent deception caused Ackman to look deeper. He began a research process that involved reading thousands of pages of SEC filings, conference-call transcripts, and rating-company and analysts' reports.

What Ackman really wanted was a face-to-face meeting with MBIA executives. In August 2002, Ackman got the chance. Robert Gendelman, a friend and at that time an investment adviser at Neuberger Berman, one of the largest holders of MBIA stock, agreed to arrange a meeting.

Several days before his visit to MBIA, Ackman e-mailed a senior insurance executive who had once worked with Brown, seeking his opinion on the executive. "He is smart and top notch," the acquaintance wrote back. And that's important because "business is dangerous, like picking up dimes in front of a steamroller."

Ackman and Gendelman made the short trip by car to MBIA's headquarters an hour north of Manhattan in the leafy Westchester suburb of Armonk. Gendelman introduced Ackman to MBIA executives as a money manager who had done a lot of research on the company.

MBIA welcomed him. The question of whether Ackman had a long or short position on MBIA never came up.

The meetings, which began around 10 in the morning and ran well into the evening, started in Brown's office. Acquaintances describe Brown as a very private person. He is also a self-made man, who sometimes told colleagues about the years he spent driving a truck before he completed college. A graduate of Northern Illinois University who had majored in statistics, Brown rose through the ranks of Fireman's Fund Insurance, starting with the company as an actuarial trainee when he was 25, eventually becoming its CEO.

Brown later advised Xerox Corporation on the sale of its insurance unit, including Crum and Forster, a 150-year-old insurer based in Morristown, New Jersey, which had huge exposure to asbestos claims. Asbestos was the miracle building material of the 1960s and 1970s. In the 1980s, however, doctors discovered that the mineral, named after the Greek word meaning "inextinguishable," lodged in the lungs of workers, remaining there for years and causing cancer and other fatal respiratory diseases. By the late 1990s, the insurance industry was bracing for asbestos-related workers' compensation claims of more than $250 billion.

Brown's ability to dispose of this toxic exposure at a profit to Xerox earned him a reputation as a dealmaker. Brown, who had served on MBIA's board since the mid-1980s, joined MBIA as its CEO in 1999 after the company's longtime president and CEO, David Elliott, suddenly stepped down. After assuming the top spot, Brown purchased more than $7 million of MBIA's shares using his own money. "He is a tough, tough man who is deceptively gentle in his demeanor," James Lebenthal, a longtime MBIA board member, said of Brown.

In his meeting with Brown at the company's headquarters that August, Ackman took notes, jotting down Brown's description of MBIA's two core businesses. "Structured finance is analyzable, understandable," Ackman noted as Brown explained the business of insuring asset-backed securities, bonds backed by everything from credit-card bills to mortgages and even other bonds.

Bankers often use the analogy of a waterfall to explain how asset-backed-securities holders are paid. Each month, payments on mortgages or credit cards flow into a trust that has issued various securities to fund the purchase of the loans. The cash is used to pay the highest-rated asset-backed-securities holders first before the overflow spills down to the next highest-rated level of securities holders and so on. Defaults on the