5/8/2018 5:40
JOHN F. WARR
COUNTY CLE
DALLAS COUN

CAUSE NO. CC-17-06253C

UNITED DEVELOPMENT FUNDING, L.P, A DELAWARE LIMITED PARTNERSHIP; UNITED DEVELOPMENT FUNDING II, L.P, A DELAWARE LIMITED PARTNERSHIP; UNITED DEVELOPMENT FUNDING III, L.P, A DELAWARE LIMITED PARTNERSHIP; UNITED DEVELOPMENT FUNDING IV, A MARYLAND REAL ESTATE INVESTMENT TRUST; UNITED DEVELOPMENT FUNDING INCOME FUND V, A MARYLAND REAL ESTATE INVESTMENT TRUST; UNITED MORTGAGE TRUST, A MARYLAND REAL STATE INVESTMENT TRUST; UNITED DEVELOPMENT FUNDING LAND OPPORTUNITY FUND, L.P., A DELAWARE LIMITED PARTNERSHIP; UNITED DEVELOPMENT FUNDING LAND OPPORTUNITY FUND INVESTORS, L.L.C., A DELAWARE LIMITED LIABILITY COMPANY	§	**IN THE COUNTY COURT OF DALLAS COUNTY, TEXAS**
Plaintiffs,	§	**COUNTY COURT OF LAW NO. 3**
v.	§	
J. KYLE BASS; HAYMAN CAPITAL MANAGEMENT, L.P.; HAYMAN OFFSHORE MANAGEMENT, INC.; HAYMAN CAPITAL MASTER FUND, L.P.; HAYMAN CAPITAL PARTNERS, L.P.; HAYMAN CAPITAL OFFSHORE PARTNERS, L.P.; HAYMAN INVESTMENTS, LLC	§	
Defendants.	§	

<u>AFFIDAVIT OF DALE KITCHENS</u>

22. Hayman Capital's assertion that UDF's business was operating as a Ponzi scheme, or in a comparable Ponzi-like manner, was false. UDF's business was not masking or engaging in financial irregularities typical of a Ponzi scheme. Hayman Capital did not show the existence of "purported returns" (i.e., fictitious returns), nor was UDF's business generating fictitious returns typical of a Ponzi scheme. UDF's loans, including to its largest borrower, Centurion, did generate cash receipts. Money did go to development. The collateral was genuine and in the process of development. It was not true that, as stated in the "Letter from Kyle Bass," UDF's business was a billion dollar house of cards, and UDF's business was not on the verge of collapse such that it faced significant bankruptcy risk that would leave the shares of investors virtually worthless.

23. To support its incorrect assertions that UDF's business was operating as a Ponzi scheme or in a manner comparable to a Ponzi scheme, Hayman Capital cherry picked some facts grossly out of context while omitting or misstating other key facts:

a. First, Hayman Capital repeatedly asserted in various ways that UDF was not generating cash receipts and instead accrued interest.[4] (See, e.g., letter to Whitley Penn, Annex 2, at 2.) The accrued interest was contrasted with cash interest and portrayed as a fictional form of interest that the "authorities" would reject. (See, e.g., Dec. 15 post, Annex 4, at 7.) Hayman Capital was misrepresenting the facts. ***UDF IV's SEC filings showed that it was in fact generating cash, and, moreover, its generation of cash had been steadily increasing.*** Generally, UDF IV's statement of cash flows show the increasing generation of cash. More specifically, on pages 56-59 of UDF IV's 10-K, UDF IV disclosed that its 2012 cash receipts for its loan portfolio were approximately $25 million, then increased to approximately $100 million in 2013, then increased to approximately $152 million in 2014. (Annex 9, at 56-59.) As for distributions to the investors in UDF IV, page F-18 of the same 10-K disclosed that UDF IV made approximately $51 million in distributions to investors in 2014, the source of which was approximately $42 million in cash from operations and approximately $9 million in borrowings under credit facilities. (Id. at F-18.) None of the funding of distributions came from offering proceeds from new investors (though there would be nothing indicative of a Ponzi scheme if funding did come in part from offering proceeds, as that is an ordinary feature of blind pool offerings for real estate investment trusts).[5] Id. Clearly,

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replacement of SAS 82 and stated in relevant part: "...the communication may use terms other than fraud – for example, irregularity, intentional misstatement, misappropriation, or defalcations – if there is possible confusion with a legal definition of fraud or other reason to prefer alternative terms."

[4] Thus, the statement by Kyle Bass in his affidavit that UDF's income represented "purported returns" based on accrued interest. (Bass Aff. ¶ 17.)

[5] UDF IV discloses that it may fund distributions from any source of funds available to it: "Our organizational documents permit us to make distributions from any source. In the event we do not have enough cash to make distributions, we may borrow, use proceeds from the Offering, issue additional securities or sell assets in order to fund distributions." (2014 10-K, Annex 9, at

UDF IV, which was the largest and the only publicly-traded UDF entity, was generating cash and doing so in increasing amounts. That is the antithesis of a Ponzi scheme. Hayman Capital has repeatedly represented that it reviewed UDF's SEC filings, (see, e.g. Parker Lewis Aff. ¶ 12; Kyle Bass Aff. ¶ 22), and its postings concerning UDF's business regularly derived information from UDF's SEC filings. But Hayman Capital omitted this critical information repudiating its purported evidence of a Ponzi scheme.

b. Second, Hayman Capital's assertion that UDF's accrual of interest was an indicium of a Ponzi scheme (because, according to Hayman Capital, the interest was not "cash interest") is incorrect. ***Accrued interest is not a "purported" or "fictitious" return; instead, it is actual income that UDF was required to recognize on its financial statements under generally accepted accounting principles.*** Indeed, there is no distinction between "cash interest" or "accrued interest" in terms of recognizing income on a financial statement; rather, there is only "interest income" which is accrued pursuant to the mandates of accrual accounting—regardless of whether that income was derived from the accrual of interest or the payment of interest in cash. Moreover, in the context of the real estate developments financed by UDF, Hayman Capital's purported distinction between "accrued interest" and "cash interest" is a straw man that it uses in support of its false assertion that UDF's business amounts to a Ponzi scheme. In

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17.) As part of its Form S-11 filed with the SEC on August 5, 2008, UDF IV disclosed that it raised money through a "blind pool" offering, in which money is raised in advance of the acquisition of real property. It is an ordinary feature of blind pool offerings in the real estate context, and not indicative of a Ponzi scheme, to give management the discretion as to how distributions may be funded, including the use of cash from operations, borrowings or offering proceeds. For example, a REIT managed by Highland Capital, which was organized as a blind pool offering in 2013, stated: "We expect that there may be times during the early stages of our development, and from time to time during our operational stage, where we may declare distributions in anticipation of cash flow that we expect to receive during a later period and we will pay these distributions in advance of our actual receipt of these funds. Should these instances occur, to the extent permitted by Maryland law, we expect to use the proceeds from this offering to pay distributions. We may borrow funds, issue new securities or sell assets to make and cover our declared distributions, all or a portion of which could be deemed a return of capital. We may also fund such distributions from third-party borrowings or from advances from our advisor or sponsor or from our advisor's deferral of its asset management fee, although we have no present intention to do so. If we fund distributions from borrowings, sales of properties or the net proceeds from this offering, we will have less funds available for the acquisition of real estate properties and real estate related assets and your overall return may be reduced. Our charter permits us to pay distributions from any source, including from offering proceeds or borrowings." (Highland Capital Realty Trust, Inc., Form S-11, at 94, attached as Annex 10.) Highland Capital Realty was, like UDF, a "blind pool" offering, id. at i, and was affiliated with Highland Capital Management, a well-known investment fund with billions of dollars under management. Its registration statement (Form S-11), states that a large national law firm, Dechert LLP, handled its legal matters. (Id., at 158.)

economic substance, what Hayman Capital refers to as "accrued interest" and "cash interest" are the same, as can be illustrated with regard to the ordinary operation of bank loans. When a developer is able to obtain a bank loan for a real estate project, the bank typically puts a portion of the loan proceeds into an interest reserve account. During the life of the loan, money is transferred from the account back to the bank on a monthly basis as "cash interest"; however, in substance, it is the bank's own money being returned to it—not cash being paid by the developer. UDF is not a bank, and, as such, is not obligated by banking rules to fund interest reserve accounts in the same manner and then pay itself "cash interest." Instead, it can simply accrue interest. In this context, "cash interest" and "accrued interest" are six of one and a half dozen of another. Whether for a bank loan or a UDF loan, the developer does not pay actual cash out of its own pocket because the real estate development is not yet generating cash. Instead, the developer is acquiring land, working through the entitlements process, and finishing lots, all of which can take years. It is not an indicium of fraudulent business activities that the developer is not paying cash interest out of the developer's own funds; instead, it is the economic reality of real estate development (for residential subdivisions such as those financed by UDF) that the cash generally does not flow until finished lots are sold to homebuilders.[6] In short, it was false for Hayman Capital to assert that cash interest is legitimate whereas accrued interest is indicative of a Ponzi scheme.

c. Third, at the time of Hayman Capital's December 10, 2015 anonymous post and thereafter, ***Hayman Capital omitted the facts that each UDF IV loan was backed by specific collateral, the value of which was regularly appraised by independent appraisers in order to secure the loan, as disclosed in its 2014 10-K.*** (Annex 9, at 35 (disclosure of independent appraisers), 56-59 (disclosure of collateral under table heading "Collateral").) These critical facts were contrary to the existence of a Ponzi scheme as asserted by Hayman Capital. A business that is operating as a Ponzi scheme would not subject its loan portfolio to outside scrutiny in the form of an independent appraisal (by way of comparison, Madoff concealed from inspection his books and records showing his holdings of securities). I have sampled UDF's records for the collateral and the independent appraisals, including for the project highlighted by Hayman Capital in its second and third anonymous posts (Shahan Prairie), and found that the appraisals of the collateral were conducted by a variety of independent appraisers in an ordinary manner. As disclosed in UDF's SEC filings, it had credit lines from banks, and those banks would have also insisted on appraisals of UDF's collateral. Hayman Capital never acknowledged that UDF's business obtained independent appraisals of its collateral. Hayman Capital did vaguely acknowledge that UDF's real estate projects were some form of collateral, but then falsely implied that the collateral was of little real

[6] Developers may sometimes obtain some cash during the development process, and prior to the sale of finished lots, via municipal utility districts, public improvement districts or other means, but it is still the sale of finished lots that is typically the primary means of generating cash.

value, or even fraudulent, because it was not generating current income.[7] However, that was not true because, as Hayman Capital omitted to disclose, a portion of the collateral was income producing while a portion was not yet income producing. If Hayman Capital had been forthcoming and stated that some collateral was income producing while some was not yet income producing, such a statement would have been unremarkable as it was entirely to be expected that, for a portfolio of real estate development projects, some collateral would be income producing and some would not yet be producing income at any given time. As disclosed, UDF's business involved long-term development activities related to the funding of land acquisition, entitlement, and the finishing of lots for sales to builders. (See, e.g., Defs.' Appendix, at 936 (disclosure from 2013 10-K of UDF III stating: "Loan proceeds may be used to fund land acquisition, entitlement costs, engineering and design and site improvements, finished lot inventory, and municipal reimbursements.")) Income is largely generated by the sales of lots at the end of the development process, and the development process (including entitlements) is unpredictable and can take years. Therefore, income generation would not be expected for many of the loans being funded by UDF because, at any given time, many of UDF's loans would not have reached the stage where finished lots were being sold to builders. In addition, a developer may decide, based on market conditions, to develop one property in a certain area at a certain time while waiting for better conditions to develop a different property at a different time.[8]

d. Fourth, Hayman Capital makes additional statements purporting to show that UDF's business is a sham based on cherry-picked "representative" samples of UDF-financed real estate projects and grossly misstates the implications of these non-representative "representative" samples. To begin, in its December 15, 2015 anonymous post, Hayman Capital first used the Shahan Prairie development as an example of where "loans issued by UDF to Centurion are collateralized by land that has never been developed (for years, not quarters)" and that "Shahan Prairie is just one example of many to come." Annex 4, at 6-7. That is factually wrong according to Plaintiffs' Petition,[9] but Hayman Capital did not stop there. To support its assertion that UDF's real estate developments were a sham and that Shahan Prairie was just one example of a broader fraudulent scheme, Hayman Capital posted "*Irregular Patterns Related to UDF's Largest*

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[7] For example, Hayman Capital stated on p. 3 of its Dec. 10, 2015 post: "Visits to actual development sites, which serve as collateral to UDF development loans, show that, in numerous instances, ***there is no development and the collateral is still non-income producing***, raw land 2, 3, 5 (as much as 10) years after loans were issued. ***Where did all the money go if not to developments***?" (Annex 2, at 3.)

[8] In contrast, construction loans involve loans to homebuilders who are building homes on finished lots. Because the construction phase is shorter and more predictable in the time to completion than the preceding development phase, time to completion can be projected with some reliability for construction loans, unlike development loans.

[9] As alleged in Plaintiffs' Petition, Shahan Prairie was in fact being developed. As further alleged, the development was slowed for site-specific reasons. (Plaintiffs' Petition, ¶¶ 97-101.)