

# Is Prison Time in the Cards for United Development Funding IV's (NASDAQ:UDF) Short Sellers?

December 11, 2015

Yesterday a consortium of short sellers, after creating a significant short position in United Development Funding IV (NASDAQ:UDF), released a 3-page anonymous short report entitled, "A Texas-Sized Scheme Exposing the Darkest Corner of the REIT Business United Development Funding." The report contained several conjectures and suppositions of fraud against UDF, even implying the company is a "Ponzi scheme." In a statement issued by the company last night, UDF replied, "We believe that this hedge fund is trying to unlawfully profit by manipulating and depressing the price of United Development Funding IV shares." United Development is a real estate investment trust (REIT) that invests primarily in secured loans for the acquisition and development of land into single-family home lots and the construction of single-family homes. UDF IV also makes strategic equity investments in residential real estate in some of the nation's largest housing markets. The company listed on NASDAQ under the symbol "UDF" in June of last year.

The short sellers' report raises many questions with us. First and foremost, why was the report anonymous? Maybe for good reason. According to Forbes and the Wall Street Journal, the last major short seller of a publicly traded company in the real estate industry Barry Minkow is currently serving a 10-year term in a federal prison in Lexington, Ky. As a teenager, Minkow began a carpet cleaning company, ZZZZ Best carpet cleaning. He took the company public at age 20, and for a brief moment Minkow was worth \$100 million on paper. The company, which turned out to be a giant ponzi scheme, collapsed in 1987. The young Minkow was slapped with 57 felonies and a 25-year prison sentence. Upon parole from prison for good behavior, Minkow became an evangelical pastor for San Diego Community Bible Church, from which he bilked over \$3 million. During the time he was bilking the church, Minkow was also busy causing the stock of Miami-based Lennar Corp (NYSE:LEN) to plunge by \$583 million within just two days in a "short-and-distort" stock fraud scheme to help a paying client extort money from the company. Minkow received 5 years for bilking the church and 5 years for the stock fraud scheme.

A Minkow-styled "short-and-distort" scheme is at play here with this band of short sellers of United Development. The report is rife with conjecture and innuendo, most of which we were able to debunk with our research. Let us go through some of the major points in this short thesis one by one:

**Point 1:** Page 3 of the short report states, “Their independent registered public accounting firm, Whitley Penn LLP, declined on November 19, 2015, to stand for reappointment as the auditor.” This is near the end of the short report, but we chose to highlight it first because **yesterday evening, we personally spoke to Mr. Larry Autrey, CPA, ABV who is the managing partner of Whitley Penn** (<http://www.whitleypenn.com/about-us/leadership/larry-autrey>). Mr. Autrey was gracious enough to return our call and he did in fact confirm that while the CPA firm did not stand for reappointment, this was not a reflection of any improprieties whatsoever in UDF’s financial statements. A filing with the Securities and Exchange Commission three weeks ago also confirms this. An excerpt from the company’s 8-K (shown below) shows that the CPA firm audited UDF’s books for 2013 and 2014, and its audit reports for those two years did not contain any adverse opinion or disclaimer of opinion (i.e. the books stated fairly the company’s results of operations and financial position for those periods of time).

**Item 4.01 Changes in Registrant’s Certifying Accountant.**

On November 19, 2015, Whitley Penn LLP (“Whitley Penn”) informed United Development Funding IV (the “Company”) that it has declined to stand for reappointment as the Company’s independent registered public accounting firm. Whitley Penn’s declination was accepted by the Company’s audit committee.

Whitley Penn’s audit reports on the Company’s consolidated financial statements for the fiscal years ended December 31, 2013 and 2014 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

During the Company’s two most recent fiscal years and the subsequent interim period from January 1, 2015 through September 30, 2015, (i) there were no disagreements between the Company and Whitley Penn on any matters of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Whitley Penn, would have caused Whitley Penn to make reference to the subject matter of the disagreement in its report on the Company’s consolidated financial statements, and (ii) there were no “reportable events” as that term is defined in Item 304(a)(1)(v) of Regulation S-K.

The Company has provided Whitley Penn with a copy of the foregoing statements and has requested and received from Whitley Penn a copy of the letter addressed to the Securities and Exchange Commission stating that Whitley Penn agrees with the above statements. A copy of the letter from Whitley Penn is attached as Exhibit 16.1 to this Form 8-K.

The Company is presently in discussions to replace Whitley Penn as the Company’s independent registered public accounting firm for the fiscal year ending December 31, 2015. The Company will file a Current Report on Form 8-K when the retention of a replacement independent registered public accounting firm has been completed.

The excerpt clearly states: “During the Company’s two most recent fiscal years and the subsequent interim period from January 1, 2015 through September 30, 2015, (i) there were no disagreements between the Company and Whitley Penn on any matters of accounting principles or practices, financial statement disclosure or auditing scope or procedure...” This begs the question: Who does the reader believe, the managing partner of the CPA firm or the anonymous short sellers?

**Point 2:** Similar to the way the CPA firm’s name is suggestively mentioned above, the short report uses the word “**appears**” multiple times to conjure up theories of improper behavior. Specifically, the report states on page 2 that, “UDF I, the first iteration, **appears** to have begun as a private entity owned by limited partners...” APPEARS to have begun. Really now. Do we use this terminology to make sound investment decisions or do we invest based upon facts? That nefarious word “**appears**” appears again two sentences later: “As UDF I began to falter during the financial crisis, it **appears** that capital from a public non-traded entity, United Mortgage Trust (UMT), was used to help bail out UDF I.” The next paragraph goes on to say, “Through this mechanism, UDF III retail capital **appears** to have been used to repay UMT retail capital which was used to bail out UDF I. And the Ponzi-like real estate scheme was set in motion.” At this point we’re left wondering if this report will state any provable facts.

**Point 3:** The short report goes on to say, “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.” Again we ask, where are these development sites, and where is the proof that these supposed sites are being used as collateral for loans? And in any case, **anyone with even a modicum of real estate development knowledge knows that such projects take years and years from conception to completion.**

**Point 4:** The short report also alleges that a fraud lawsuit naming UDF as co-defendant was filed in Travis County, TX. We were not able to confirm or deny this allegation because we were not able to find any proof one way or the other. Even if this allegation is true, companies get sued all the time for one reason or the other.

**Here are some of the facts we have uncovered in the course of our research that debunks most if not all of the short sellers’ allegations:**

**Fact 1:** **Fact 1 was previously covered on page 1 of this report. The CPA firm stands by the company’s financial statements that it audited for the most recent two fiscal years. Furthermore, the firm has not detected any adverse reportable conditions for the current fiscal year.**

**Fact 2:** **According to SEC filings, on September 5<sup>th</sup>, 2013, the SEC sent UDF a letter asking the company to restate its financial statements to expense its placement fees rather than deferring them in its 2011 financial statements (see excerpt below).**

Form 10-K for the Fiscal Year Ended December 31, 2011 filed March 30, 2012

Acquisition and Origination Fees, F-10

1. We note your response to comment one in our letter dated July 17, 2013. We do not agree with your conclusion that the placement fees paid to your asset manager should be deferred since you are unable to determine the amount of placement fees that meets the criteria for direct loan origination costs that also would not have been incurred but for the loans originated for your fund. Please restate your financial statements to expense the placement fees as incurred. For reference see ASC 310-20-25-25.

The company retained the legal services of K&L Gates LLP and the Consulting Services of Navigant Consultant to assist in determining the correct accounting treatment for loan origination costs under U.S. generally accepted accounting principles ("GAAP"), which is contained in the Financial Accounting Standards Board's ("FASB") Accounting Standards Code. As a result of this review, the company determined that its financial statements for 2009, 2010, 2012, and a portion of 2013 contained accounting errors. The CPA firm concurred with this assessment and amended financial statements were filed. During this period, the company released the following statement, which was taken from the SEC website:

"From the year ended December 31, 2009 through the quarter ended September 30, 2013, we capitalized Acquisition and Origination Fees incurred and amortized them into expense on a straight-line basis over our expected economic life. U.S. generally accepted accounting principles ("GAAP") guidance in FASB ASC 310-20 requires direct loan origination costs, including the portion of total compensation paid to employees engaged in direct loan origination activities, to be capitalized and amortized into expense over the life of the related loan, provided that records are available in sufficient detail to reliably determine the amount of qualifying direct loan origination costs incurred. In our case, employees of UMTD LD were performing loan origination activities in consideration for our payment of Acquisition and Origination Fees. However, UMTD LD did not maintain (and we did not require them to maintain) contemporaneous, sufficiently detailed time records on a loan by loan basis for all years that would provide evidence of the amount of time allocable to direct loan origination activities and thus the amount of Acquisition and Origination Fees allowable for deferral under ASC 310-20. Therefore, we have concluded that we were unable to reasonably determine the amount of Acquisition and Origination Fees allowable for deferral under ASC 310-20. As a result, we have restated our previously issued financial results to expense the Acquisition and Origination Fees as incurred, rather than capitalizing and amortizing them into expense over the life of the loan. This Amended Form 10-Q includes restated information as of December 31, 2012 and for the three and nine month periods ended September 30, 2013 and September 30, 2012."

**Fact 3:** According to an SEC filing last year, “On February 3, 2014, the Board of Directors of United Development Funding IV (the “Registrant”) appointed Stacey H. Dwyer as the Chief Operating Officer of the Registrant, effective February 17, 2014. Ms. Dwyer, age 47, is joining the Registrant from D.R. Horton, Inc., a homebuilding company, where she served as the executive vice president since 2000 and as treasurer since 2003. Ms. Dwyer was primarily responsible for financial community relations, including banks, investors, rating agencies and analysts. Prior to joining D.R. Horton in 1991, Ms. Dwyer was an auditor with Ernst and Young, LLP. Ms. Dwyer is a **certified public accountant** and received a B.S. in accounting from Southeastern Oklahoma State University and an M.S. in accounting from the University of Texas at Arlington.” The company’s COO is certainly no light weight.

**Fact 4:** According to page 83 of the firm’s 10-Q filing last month with the SEC reporting its financial statements for the 3<sup>rd</sup> Quarter of 2015, Ms. Dwyer chose to receive her \$350,000 annual bonus in a combination of cash and stock in the company. See excerpt below:

12/11/2015 [www.sec.gov/Archives/edgar/data/1440292/000114420415063906/v423157\\_10q.htm](http://www.sec.gov/Archives/edgar/data/1440292/000114420415063906/v423157_10q.htm)

Pursuant to her employment agreement, Ms. Dwyer receives an annual minimum guaranteed bonus of \$350,000. The bonus for a preceding calendar year will be paid to Ms. Dwyer on or before June 30 of the year following the year that the bonus was earned. At Ms. Dwyer’s discretion, she can choose to receive the bonus in cash or in common shares of beneficial interest of the Trust, or any combination thereof. Ms. Dwyer’s 2014 bonus (prorated based on an effective employment date of February 17, 2014) was accrued and included in general and administrative expense during the year ended December 31, 2014. On June 30, 2015, as payment for her 2014 bonus, Ms. Dwyer elected to receive 10,000 common shares of beneficial interest with the remainder of her 2014 bonus payable in cash. The closing per share price of UDF IV shares on June 30, 2015 was \$17.48.

While we do not personally know Ms. Dwyer, based upon her impressive resume above, we believe her to be an intelligent person. Why would she take half of her annual bonus in cash and the other half in the company’s stock if she believed the company to be an illicit Ponzi scheme whose shares could tumble at any time? Normal human behavior dictates that a rational person would have taken their entire bonus in cash if that were the case. Moreover, given that Ms. Dwyer is an insider of the company dealing personally with the SEC’s inquiry, if she believed the company was in imminent danger of dire SEC sanctions, that would be further reason to take all her compensation in cash.

**Fact 5:** The company's most recent Balance Sheet shows a little over \$654 million in a combination of interest and notes receivables. Of that amount, only approximately 17% or \$111 million is from related parties. See excerpt below:

12/11/2015 www.sec.gov/Archives/edgar/data/1440292/000114420415063906/v423157\_10q.htm

**PART I  
FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**UNITED DEVELOPMENT FUNDING IV  
CONSOLIDATED BALANCE SHEETS**

	<u>September 30, 2015 (Unaudited)</u>	<u>December 31, 2014</u>
<b>Assets</b>		
Cash and cash equivalents	\$ 18,979,309	\$ 30,481,912
Restricted cash	8,762,368	7,048,976
Accrued interest receivable	29,817,746	18,098,976
Accrued receivable – related parties	6,207,849	3,343,867
Loan participation interest – related parties, net	35,255,640	40,658,253
Notes receivable, net	513,177,132	508,435,988
Notes receivable – related parties, net	69,644,615	60,497,391
Lot inventory	-	10,621,316
Other assets	2,214,647	2,966,105
<b>Total assets</b>	<u>\$ 684,059,306</u>	<u>\$ 682,152,784</u>

**Conclusion:** During the course of our review, we noticed that appropriate disclosures were made public and were timely filed with the SEC, the company made every effort to comply with the SEC's guidelines, financial statements for prior years were restated as necessary, and the CPA firm stands by the company's most 2 recent fiscal years audits as well as the year to date financial situation of United Development. We therefore conclude that this consortium of anonymous short sellers in this particular case have taken a molehill and turned it into a mountain for the sole specific purpose of driving the company's stock down to collect a tidy profit. Should their real identities come to light, they may be the ones on the opposite end of the law's wrath.

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