



UDF Management Lacks Credibility

# How UDF Management Has Not Recognized Realized Losses in a Public Affiliate

February 2016

“Only when the tide goes out do you discover who’s been swimming naked.”

– Warren Buffett

# HOW UDF MANAGEMENT HAS NOT RECOGNIZED REALIZED LOSSES AND THE IMPLICATIONS FOR UDF

1. Pre-dating the financial crisis, UDF management used public shareholder capital through a public SEC-registered UDF affiliate to issue loans to private entities owned and controlled by approximately 10 UDF insiders (the “Insider Entities”), including key executives Hollis Greenlaw and Todd Etter.
2. In turn, the Insider Entities then issued loans to third-parties.
3. During and subsequent to the financial crisis, the loans to third parties stopped performing and the collateral securing these loans was foreclosed upon and sold for less than the balance of the loans, resulting in significant realized losses.
4. As a result, the Insider Entities were unable to repay the loans issued by the public SEC-registered UDF affiliate, United Mortgage Trust.
5. Rather than recognize the realized losses in the income statement of the public affiliate, UDF’s management obscures the losses and keeps them “on balance sheet” by issuing “deficiency notes” and “recourse obligations,” which are effectively IOUs.
6. This is consistent with how management operates UDF III and UDF IV – obscuring and not recognizing losses on non-performing loans.
7. When UDF management claims publicly that UDF IV has not “realized” any losses, investors should question why management used the term “realized” rather than “incurred.” Investors should question management about the extent of “unrealized” or “incurred” losses that may exist.



# WHY UDF MANAGEMENT LACKS CREDIBILITY

**Management and insiders suffered tremendous losses on loans issued pre-financial crisis by a public UDF affiliate** (which they managed but did not own) **to their own private entities** (which they not only managed but also owned). When the loans stopped performing during and subsequent to the financial crisis, the insiders, through the private entities, foreclosed on the collateral and sold the underlying real estate assets resulting in considerable realized (and crystallized) losses to the insiders and their private entities. However, to date, these **losses have never been recognized in the income statement of United Mortgage Trust (“UMT”), the public entity**. Instead, management issued opaque and official sounding instruments called unsecured **deficiency notes** and **recourse obligations** (“Deficiency Notes”) to their private entities (currently with an outstanding **balance of \$73 million**). As a result, the losses that resulted from poor investment decisions over eight years ago are still shown as “assets” of UMT. While management refers to these assets as “deficiency notes” and “recourse obligations,” in reality, these are just I-OWE-YOUs that management has never repaid.

Deficiency Notes issued to insiders, through their private entities, bear interest at 1.75% while similar Deficiency Notes issued to third-parties bear interest at 14.0%. **Apparently, insiders and management believe that their private entities are more creditworthy than third-parties and even the U.S. government (the U.S. 10-year treasury has averaged 2.70% since 2007 when the first Deficiency Note was issued)**. The below market interest rate and the differential in the interest rate charged on third-party Deficiency Notes suggests (i) the insider Deficiency Notes are not arms’ length transactions and (ii) there is a conflict of interest. Not only is the interest rate on insider Deficiency Notes below market, management has not moved to collect on the \$73 million in Deficiency Notes for the better part of a decade. The logical explanation as to why management has not collected on the Deficiency Notes would seem to be because Hollis Greenlaw and other insiders would be forced to collect on their own private entities (aka themselves).

The private entity that ultimately owes a considerable amount of these Deficiency Notes, UMT Holdings (“UMTH”), is owned by 10 insiders, including Hollis Greenlaw and Todd Etter (CEO and Chairman, respectively) who combine to own 60% of UMTH. UMTH also happens to be the external manager of all four public UDF affiliated programs, and accordingly, UMTH’s primary revenue source is the fee stream generated from UDF’s four public affiliates. Effectively, UMTH’s ability to repay the Deficiency Notes is heavily dependent on extracting sufficient fees from UMT, UDF III, UDF IV and UDF V. **This would seem to create a significant conflict of interest that is not disclosed to shareholders of UDF III, UDF IV and UDF V** – given that management needs fees from UDF III, UDF IV and UDF V to repay a debt owed to UMT while at the same time managing all four public companies.

The following analysis explains in detail what a Deficiency Note is, how Deficiency Notes came to be and the implications for UDF IV. While the specific public UDF entity involved is UMT, the management team running UMT is the same management team running UDF III, UDF IV and UDF V. Similarly, the same audit firm that audited UMT also audited UDF III, UDF IV and UDF V. This analysis raises serious questions regarding UDF management’s credibility. Not only does the analysis establish management’s poor investment track record, but **more importantly, it establishes management’s practice of not recognizing actual, realized losses in the financial statements (specifically the income statement) of a public company (UMT) registered with the SEC**. It further suggests that management has allowed a conflict of interest to manifest itself in the form of non-arms’ length loans to UDF management and insiders, through their private entities, with interest rates far below a market rate. This is not only how UDF management operates UMT; it is also consistent with how management operates UDF III and UDF IV – obscuring and not recognizing losses on non-performing loans.

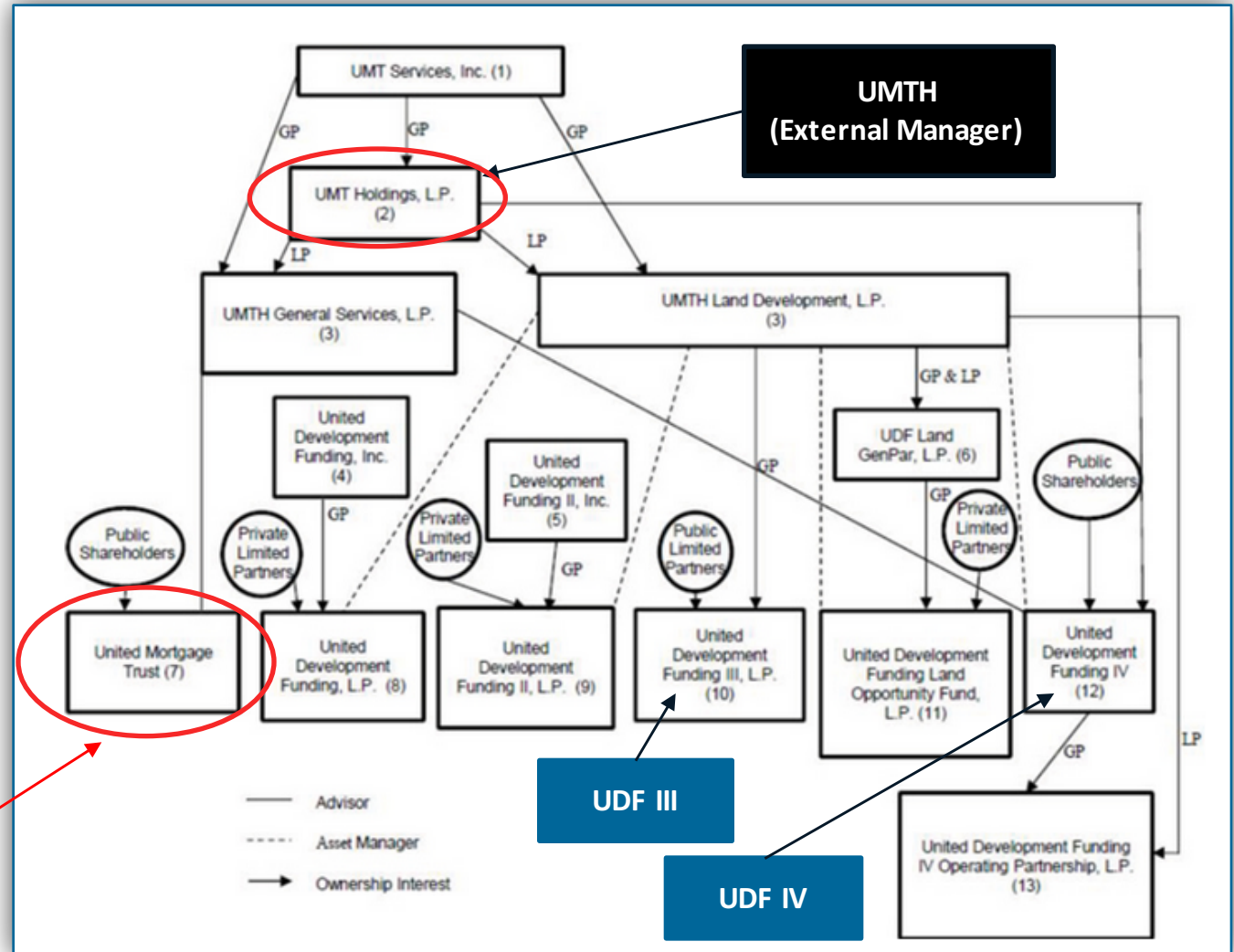


# WHERE UMT FITS INTO THE UDF SCHEME

United Mortgage Trust (“UMT”), an affiliated UDF entity, lends to entities owned principally by UDF management and other insiders, including through UDF’s external manager, UMTH, for the purpose of lending to “third-parties”.

It is unclear why UMT did not issue the loans directly to third-parties, but instead lent to private entities controlled by management and insiders, which then lent to third-parties.

**UMT  
(This One)**



**UDF III**

**UDF IV**

# RELATED PARTY ASSETS = ~85% OF TOTAL ASSETS

Of UMT's total "book value" of assets (\$182mm), related party assets account for ~85%.

These "assets" come in the form of loans to related parties including UMTH, the external manager of UDF's public affiliates, and UDF I.

Of the related party assets, deficiency notes and recourse obligations ("Deficiency Notes") represent ~50%, or \$73mm.

Deficiency Notes are better described as "I-OWE-YOUS" owed by management and insiders, through private entities.

	September 30, 2015 (unaudited)	December 31, 2014 (audited)
<b>Assets:</b>		
Cash and cash equivalents	\$ 611,761	\$ 984,841
Mortgage investments:		
Investment in trust receivable	330,082	536,084
Investment in residential mortgages	-	159,375
Interim mortgages, related party	-	15,830,254
Allowance for loan losses	-	(105,462)
<b>Total mortgage investments, net</b>	<b>330,082</b>	<b>16,420,251</b>
<b>Lines of credit receivable, related parties</b>	<b>80,387,639</b>	<b>90,844,122</b>
Lines of credit receivable	13,844,088	15,706,986
Accrued interest receivable	2,411,297	4,234,105
Accrued interest receivable, related parties	1,847,240	13,025,687
Reserves – accrued interest receivable	(1,822,025)	(5,027,174)
<b>Recourse obligations, related parties</b>	<b>31,588,811</b>	<b>20,190,990</b>
Real estate owned, net	9,449,935	4,439,004
Deficiency notes	3,235,770	3,258,330
<b>Deficiency note, related party</b>	<b>41,347,144</b>	<b>28,739,855</b>
Allowance for loan losses – deficiency notes	(1,204,049)	(591,447)
Other assets	302,059	394,783
<b>Total assets</b>	<b>\$ 182,329,752</b>	<b>\$ 192,620,333</b>

Primary Related Party Assets (in red)



# WHAT ARE “DEFICIENCY NOTES”?

“[UMT] has made loans in the normal course of business to . . . related parties, the proceeds . . . have been used to originate underlying loans”

“If the borrower or [UMT] foreclosed on property securing an underlying loan . . . and the proceeds from the sale were **insufficient to pay** the loan, the originating company had the option of (1) repaying the outstanding balance . . . or (2) **delivering to the Company an unsecured deficiency note**”

In other words, a Deficiency Note is a realized loss that is not recognized by UMT in its income statement. Instead, the loss remains on balance sheet as a promise-to-pay or an I-OWE-YOU.

## 5. Deficiency Notes – Related Party and Non Related Party

The Company has made loans in the normal course of business to related parties and non-related parties, the proceeds from which have been used to originate underlying loans that are pledged to the Company as security for such obligations. When principal and interest on an underlying loan is due in full, at maturity or otherwise, the corresponding obligation owed by the originating company to the Company is also due in full. If the borrower or the Company foreclosed on property securing an underlying loan, or if the Company foreclosed on property securing a purchased loan, and the proceeds from the sale were insufficient to pay the loan in full, the originating company had the option of (1) repaying the outstanding balance owed to the Company associated with the underlying loan or purchased loan, as the case may be, or (2) delivering to the Company an unsecured deficiency note in the amount of the deficiency.

As of September 30, 2015, the Company had two deficiency notes with non-related parties totaling approximately \$3,236,000. One note in the amount of approximately \$1,703,000 bears interest at a rate of 14% per annum. The second note in the amount of approximately \$1,533,000 had a reserve of approximately \$1,204,000. The Company does not accrue interest on this second note as the underlying collateral value approximates the note balance, net of reserves.

As of December 31, 2014, the Company had two deficiency notes with non-related parties totaling of approximately \$3,258,000. One note in the amount of approximately \$1,725,000 bears interest at a rate of 14% per annum. The second note in the amount of approximately \$1,533,000 had a reserve of approximately \$591,000. The Company does not accrue interest on this second note as the underlying collateral value approximates the note balance, net of reserves.

As of December 31, 2007, UMTH Lending Company, L.P. (“UMTHLC”) issued to the Company a variable amount promissory note in the amount of \$5,100,000 to evidence its deficiency obligations to the Company. The initial principal amount of the note was approximately \$1,848,000. The principal balance as of December 31, 2014 was approximately \$28,740,000. Effective January 1, 2015, UMT entered into a loan modification agreement (“Agreement”) with UMTH in which the UMTHLC indebtedness is evidenced by two notes – Note 1 which bears interest at the rate of 1.75% and Note 2 which bears interest at the rate of 2.70%. Both notes mature on December 31, 2017. Under the terms of the modification agreement the following amounts were rolled into the modified UMTHLC Deficiency Note: (1) accrued interest of approximately \$3,333,000, (2) the principal balance and related accrued interest of the UMTHLC Secured Line of Credit Promissory Note of approximately \$11,376,000. As of September 30, 2015, the total outstanding principal balance of the modified UMTHLC Deficiency Notes was approximately \$41,347,000. From December 31, 2007 through September 30, 2015 the Company has received approximately \$11,930,000 in aggregate principal and interest payments under the UMTHLC Promissory Note. Please see Note 4 above for additional information regarding the Agreement.

### *The Translation:*

**UMT lent to affiliated entities that lent to third-parties; when the loans to third-parties went bad, the affiliated entities could not repay the UMT loans and instead provided UMT with deficiency notes...the ‘I OWE YOU’**



# WHO OWES THE “DEFICIENCY NOTES”?

“*UMTH Lending Company, L.P.* (‘UMTHLC’) issued to [UMT] a variable amount promissory note [...] *to evidence its deficiency obligations* to the [UMT].”

The legal entity that owes the Deficiency Notes, UMTHLC, is ultimately owned by 10 insiders, (see following page).

The balance has grown from \$5.1 million as of December 2007 to \$41.3 million as of September 2015.

## 5. Deficiency Notes – Related Party and Non Related Party

The Company has made loans in the normal course of business to related parties and non-related parties, the proceeds from which have been used to originate underlying loans that are pledged to the Company as security for such obligations. When principal and interest on an underlying loan is due in full, at maturity or otherwise, the corresponding obligation owed by the originating company to the Company is also due in full. If the borrower or the Company foreclosed on property securing an underlying loan, or if the Company foreclosed on property securing a purchased loan, and the proceeds from the sale were insufficient to pay the loan in full, the originating company had the option of (1) repaying the outstanding balance owed to the Company associated with the underlying loan or purchased loan, as the case may be, or (2) delivering to the Company an unsecured deficiency note in the amount of the deficiency.

As of September 30, 2015, the Company had two deficiency notes with non-related parties totaling approximately \$3,236,000. One note in the amount of approximately \$1,703,000 bears interest at a rate of 14% per annum. The second note in the amount of approximately \$1,533,000 had a reserve of approximately \$1,204,000. The Company does not accrue interest on this second note as the underlying collateral value approximates the note balance, net of reserves.

As of December 31, 2014, the Company had two deficiency notes with non-related parties totaling of approximately \$3,258,000. One note in the amount of approximately \$1,725,000 bears interest at a rate of 14% per annum. The second note in the amount of approximately \$1,533,000 had a reserve of approximately \$591,000. The Company does not accrue interest on this second note as the underlying collateral value approximates the note balance, net of reserves.

As of December 31, 2007, UMTH Lending Company, L.P. (“UMTHLC”) issued to the Company a variable amount promissory note in the amount of \$5,100,000 to evidence its deficiency obligations to the Company. The initial principal amount of the note was approximately \$1,848,000. The principal balance as of December 31, 2014 was approximately \$28,740,000. Effective January 1, 2015, UMT entered into a loan modification agreement (“Agreement”) with UMTH in which the UMTHLC indebtedness is evidenced by two notes – Note 1 which bears interest at the rate of 1.75% and Note 2 which bears interest at the rate of 2.70%. Both notes mature on December 31, 2017. Under the terms of the modification agreement the following amounts were rolled into the modified UMTHLC Deficiency Note: (1) accrued interest of approximately \$3,333,000, (2) the principal balance and related accrued interest of the UMTHLC Secured Line of Credit Promissory Note of approximately \$11,376,000. As of September 30, 2015, the total outstanding principal balance of the modified UMTHLC Deficiency Notes was approximately \$41,347,000. From December 31, 2007 through September 30, 2015 the Company has received approximately \$11,930,000 in aggregate principal and interest payments under the UMTHLC Promissory Note. Please see Note 4 above for additional information regarding the Agreement.

### *The Translation:*

**UMT lent to affiliated entities that lent to third-parties; when the loans to third-parties went bad, the affiliated entities could not repay the UMT loans and instead provided UMT with deficiency notes...the ‘I OWE YOU’s are \$41mm.**



CONTINUED

# WHO OWES THE “DEFICIENCY NOTES”?

**UMTHLC** owes the related party Deficiency Note; UMTHLC is 99.9% **owned by UMT Holdings (UMTH)**.

UMTH is majority owned by Hollis Greenlaw and Todd Etter, CEO and Chairman of UDF, respectively.

*The Translation:*

**UMT lent to [UMTHLC which is owned by UMTH which is owned by] the same people that externally manage UMT and UDF entities; these individuals, through UMTH, owe a significant amount of debt to UMT in the form of deficiency notes.**

United Mortgage Trust Related Party Relationships			
Company	Affiliation	Governance	Ownership
UMT Holdings, L.P. ("UMTH")	99.9% owner of our borrower, UMTHLC and our advisor, UMTHGS	UMT Services, Inc. serves as General Partner	10 Limited Partners
UMTH Lending Company, L.P. ("UMTHLC")	Borrower	UMT Services, Inc. serves as General Partner	99.9% owned by UMTH
UMTH Land Development, L.P. ("UMTHLD")	Asset Manager for UDF I and General Partner of UDF III	UMT Services, Inc. serves as General Partner	99.9% owned by UMTH
United Development Funding, L.P. ("UDF I")	Borrower	United Development Funding, Inc., serves as General Partner	41 Limited Partners
United Development Funding III, L.P. ("UDF III")	Loan Participant	UMTHLD serves as General Partner	9003 Limited Partners
Capital Reserve Group, Inc. ("CRG")	Borrower	2 UMTH Limited Partners serve as directors	Owned by 2 UMTH Limited Partners
Ready America Funding Corp. ("RAFC")	Borrower	2 UMTH Limited Partners serve as directors	Beneficially owned by 2 UMTH Limited Partners
South Central Mortgage, Inc. ("SCMI")	Note Seller	One UMTH Limited Partner serves as director	Beneficially owned by 1 UMTH Limited Partner
Wonder Funding, L.P. ("Wonder")	Borrower	One UMTH Limited Partner serves as director	Beneficially owned by 1 UMTH Limited Partner

Source: United Mortgage Trust Proxy Statement (4.29.15)

(2) UMT Services serves as the general partner and owns 0.1% of the limited partnership interests in UMT Holdings, L.P. ("UMT Holdings"). The remaining 99.9% of the limited partnership interests in UMT Holdings are held as follows as of December 31, 2014: Mr. Etter (30.00%), Mr. Greenlaw (30.00%), Craig A. Pettit (5.00%), Timothy J. Kopacka (4.84%), Michael K. Wilson (7.41%), Christine A. Griffin (1.95%), Cara D. Obert (4.82%), William E. Lowe (1.06%), Ben L. Wissink (10.09%) and Melissa H. Youngblood (4.83%).

Source: UDF IV 10K (12.31.14) – this footnote (2) corresponds to the org chart on page 24.



## CONTINUED

# WHO OWES THE “DEFICIENCY NOTES”?

Not only do UDF insiders owe the Deficiency Notes through UMT Holdings (“UMTH”), but this entity has a **partners’ deficit** of **\$41.3 million (negative balance)**

The primary balance sheet asset is “accounts receivable – related parties” which are primarily fees owed by UDF III and UDF IV and other UDF-managed affiliates.

It would be one thing if the entity that owed the Deficiency Notes had a balance sheet that would indicate an ability to pay; this balance sheet does not.

*The Translation:*

**The insiders’ entity that owes the Deficiency Notes is balance sheet insolvent.**

UMT HOLDINGS, L.P.		
CONSOLIDATED BALANCE SHEETS		
	December 31,	
	2014	2013
<b>Assets</b>		
Cash and cash equivalents	\$ 411,665	\$ 789,496
Accounts receivable	164,640	41,392
Accounts receivable - related parties	18,051,480	11,184,064
Profits interest receivable - related parties	75,647	75,647
Investment in partnerships	1,239,434	846,435
Notes receivable, net of reserves for loan losses of \$121,428 and \$124,764, respectively	11,417,789	11,657,783
Notes receivable - related parties	-	4,219,971
Property and equipment, net of accumulated depreciation of \$1,516,380 and \$1,337,915, respectively	449,396	373,286
Other assets, net of accumulated amortization of \$2,011,045 and \$1,985,974, respectively	639,843	694,421
<b>Total assets</b>	<b>\$ 32,449,894</b>	<b>\$ 29,882,495</b>
<b>Liabilities and Partners’ Deficit</b>		
Accounts payable and accrued liabilities	\$ 3,425,784	\$ 2,192,894
Accounts payable - related parties	9,783,187	10,294,069
Lines-of-credit	5,343,808	6,430,475
Notes payable	339,454	166,441
Notes payable - related parties	54,895,255	57,431,245
<b>Total liabilities</b>	<b>73,787,488</b>	<b>76,515,124</b>
<b>Commitments and contingencies</b>		
<b>Partners’ deficit:</b>		
General partner’s deficit	(4,746,848)	(10,165,880)
Series A limited partners’ deficit	(20,670,000)	(20,670,000)
Class C limited partners’ deficit	(12,783,542)	(12,677,643)
Class D limited partners’ deficit	(3,137,204)	(3,119,106)
<b>Total partners’ deficit</b>	<b>(41,337,594)</b>	<b>(46,632,629)</b>
<b>Total liabilities and partners’ deficit</b>	<b>\$ 32,449,894</b>	<b>\$ 29,882,495</b>

See accompanying notes to consolidated financial statements.



# WHAT IS THE INTEREST RATE ON “DEFICIENCY NOTES”?

Primary *interest rate: 1.75%*

This rate of interest is below the 10-year U.S. treasury, far below a market rate for an investment grade credit and even further *below a market rate* for an unsecured Deficiency Note.

*The interest rates on Deficiency Notes owed by insiders (1.75%) are significantly lower than the Deficiency Notes owed by third-parties (14.0%).*

This does not appear to be an arms’ length transaction; instead, it appears to be *evidence of a conflict of interest.*

## 5. Deficiency Notes – Related Party and Non Related Party

The Company has made loans in the normal course of business to related parties and non-related parties, the proceeds from which have been used to originate underlying loans that are pledged to the Company as security for such obligations. When principal and interest on an underlying loan is due in full, at maturity or otherwise, the corresponding obligation owed by the originating company to the Company is also due in full. If the borrower or the Company foreclosed on property securing an underlying loan, or if the Company foreclosed on property securing a purchased loan, and the proceeds from the sale were insufficient to pay the loan in full, the originating company had the option of (1) repaying the outstanding balance owed to the Company associated with the underlying loan or purchased loan, as the case may be, or (2) delivering to the Company an unsecured deficiency note in the amount of the deficiency.

As of September 30, 2015, the Company had two deficiency notes with non-related parties totaling approximately \$3,236,000. One note in the amount of approximately \$1,703,000 bears interest at a rate of 14% per annum. The second note in the amount of approximately \$1,533,000 had a reserve of approximately \$1,204,000. The Company does not accrue interest on this second note as the underlying collateral value approximates the note balance, net of reserves.

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As of December 31, 2007, UMTH Lending Company, L.P. (“UMTHLC”) issued to the Company a variable amount promissory note in the amount of \$5,100,000 to evidence its deficiency obligations to the Company. The initial principal amount of the note was approximately \$1,848,000. The principal balance as of December 31, 2014 was approximately \$28,740,000. Effective January 1, 2015, UMT entered into a loan modification agreement (“Agreement”) with UMTH in which the UMTHLC indebtedness is evidenced by two notes – Note 1 which bears interest at the rate of 1.75% and Note 2 which bears interest at the rate of 2.70%. Both notes mature on December 31, 2017. Under the terms of the modification agreement the following amounts were rolled into the modified UMTHLC Deficiency Note: (1) accrued interest of approximately \$3,333,000, (2) the principal balance and related accrued interest of the UMTHLC Secured Line of Credit Promissory Note of approximately \$11,376,000. As of September 30, 2015, the total outstanding principal balance of the modified UMTHLC Deficiency Notes was approximately \$41,347,000. From December 31, 2007 through September 30, 2015 the Company has received approximately \$11,930,000 in aggregate principal and interest payments under the UMTHLC Promissory Note. Please see Note 4 above for additional information regarding the Agreement.

*The Translation:*

**Apparently, insiders and management believe, despite the realized losses, that their private entities are more creditworthy than the U.S. government.**



# AND WHAT IS A RECOURSE OBLIGATION?

The definition of a *recourse obligation* is almost *identical* to the definition of a *Deficiency Note*.

The recourse obligations are also owed by management and insiders, through private entities, similar to the Deficiency Notes.

The primary interest rate on recourse obligations is also **1.75%**, *which is far below a market rate*.

6) Recourse Obligations. The Company has made recourse loans to (a) CRG, which is a Texas corporation that is 50% owned by Todd Etter (a UMTH partner) and William Lowe (a former UMTH partner), which owns the Advisor, (b) RAFC, which is owned by SCMI and two companies owned by Craig Pettit, Eastern Intercorp, Inc. and RMC, and (c) SCMI, which is owned by Todd Etter, (these companies are referred to as the "originating companies"). In addition to the originating companies discussed above, the Company made loans with recourse to Wonder. Each of these entities used the proceeds from such loans to originate loans, that are referred to as "underlying loans," that are pledged to the Company as security for such originating company's obligations to the Company. When principal and interest on an underlying loan are due in full, at maturity or otherwise, the corresponding obligation owed by the originating company to the Company is also due in full.

In addition, some of the originating companies have sold loans to the Company, referred to as the "purchased loans," and entered into recourse agreements under which the originating company agreed to repay certain losses the Company incurred with respect to purchased loans.

If the originating company forecloses on property securing an underlying loan, or the Company forecloses on property securing a purchased loan, and the proceeds from the sale are insufficient to pay the loan in full, the originating company has the option of (1) repaying the outstanding balance owed to the Company associated with the underlying loan or purchased loan, as the case may be, or (2) delivering an unsecured Deficiency Note in the amount of the deficiency to the Company.

On March 30, 2006, but effective December 31, 2005, the Company and each originating company agreed to consolidate (1) all outstanding amounts owed by such originating company to the Company under the loans made by the Company to the originating company and under the Deficiency Notes described above and (2) the estimated maximum future liability to the Company under the recourse arrangements described above, into secured promissory notes ("Recourse Obligations"). Each originating company issued to the Company a secured variable amount promissory note dated December 31, 2005 (the "Secured Notes") in the principal amounts shown below, which amounts represent all principal and accrued interest owed as of such date. The initial principal amounts are subject to increase if the Company incurs losses upon the foreclosure of loans covered by recourse arrangements with the originating company. The Secured Notes (including related guaranties discussed below) are secured by an assignment of the distributions on the Class C units and Class D units of limited partnership interest of UMT Holdings held by each originating company.

*The Translation:*

**Recourse obligations are almost the same as Deficiency Notes.  
Recourse obligations are also owed by management and insiders, through private entities, and the primary interest rate is also 1.75%.**



# BREAKING DOWN A NEW “RECOURSE OBLIGATION”

This recent example from September 2015 highlights the critical issue with recourse obligations (and Deficiency Notes) and the broader implications.

In this case, a UMT loan issued to an insider’s entity (RAFC), which was secured by real estate, was admittedly **impaired** by ~67% **but management still did not recognize the loss.**

**The loan had a balance of \$15.8 million; the value of the underlying real estate was only \$5.1 million.**

Despite this fact, management had not previously reserved for the \$10.7mm loss on this loan; **when it foreclosed, management simply added the loss to the insider “recourse obligation” rather than recognizing the loss in its income statement.**

By not recognizing the loss in its income statement, the financial condition of UMT has been obscured.

## Interim Loan Portfolio Overview

We believe that a pragmatic and pro-active approach to managing our interim loan credits will allow us to maximize repayments and properly report asset values. As part of our transition away from Interim Loans:

- Beginning March 2008, ceased the origination of, and reduced our investment in, interim loans dependent on sub-prime and Alt-A mortgage products for repayment of our loan.
- Effective December 31, 2007, accepted a secured note from UMTHLC for shortfalls from foreclosed properties to enable UMTHLC to efficiently manage past due and foreclosed accounts throughout the duration of the credit crisis.  
In addition we have:
  - Increased loss reserves for certain deficiency loans where full collection of the indebtedness is not assured.
  - Periodically re-evaluated collateral values on specific loans deemed to be affected by current mortgage and housing environments and reserved for unsecured deficiencies.
- On September 14, 2015 the Company foreclosed on the real estate securing the one remaining interim loan. The estimated value of the real estate is \$5,135,000 and is included in Real estate owned, net on the balance sheet. The deficiency of \$10,695,000 is guaranteed by RAFC and was added to the RAFC Recourse Obligation balance.

### The Translation:

Once again, management did not recognize a realized loss; instead, it added the realized loss to the “recourse obligation” balance owed by insiders, through private entities, which bears interest at 1.75%.

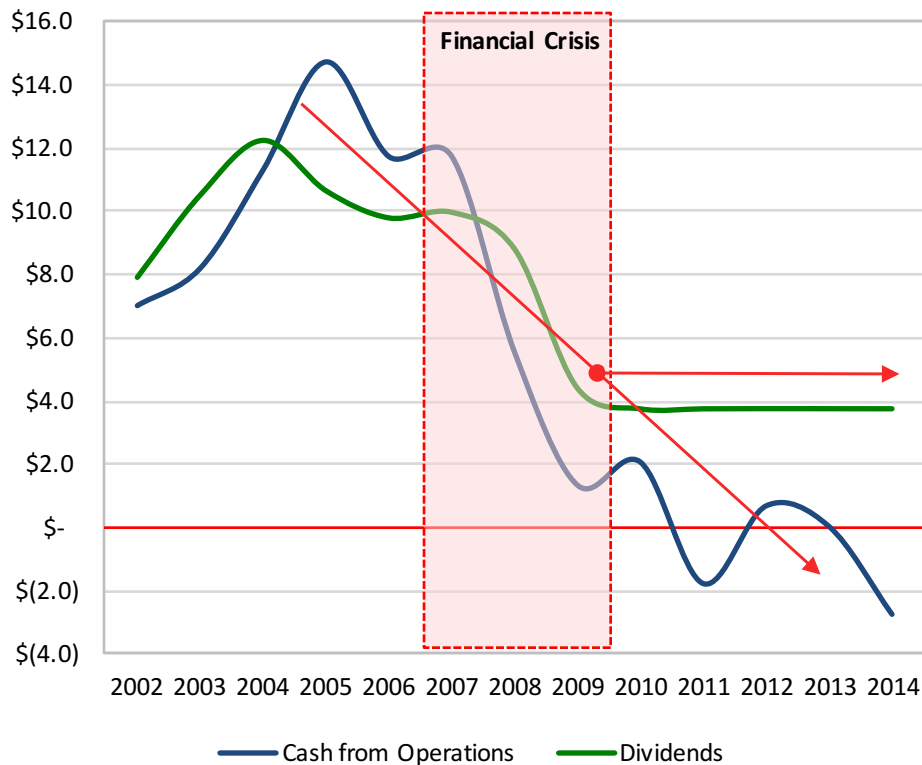
When UDF management claims that UDF IV has not “realized” any losses, investors should question why they used the term “realized” rather than “incurred.” Even when losses are “realized,” management does not “recognize” the losses. Imagine how management treats losses that have been incurred but just not yet “realized.”



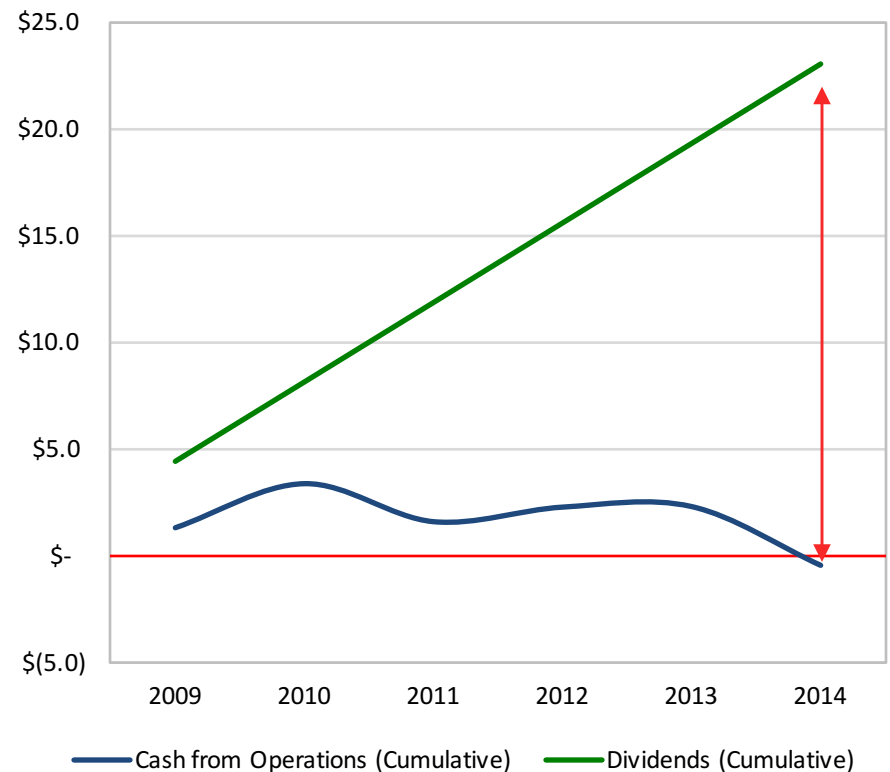
# A PICTURE IS WORTH A THOUSAND WORDS

As UMT's business deteriorated during the financial and housing crisis, management decided to peg the dividend despite the fact that the company has not generated any cash, on a cumulative basis, for the six years following the crisis; UDF III and UDF IV have both provided liquidity to UMT (by acquiring old loans from UMT) which appears to be how UMT continued to fund distributions to its public shareholders.

**UMT Annual Cash from Operations vs. Annual Dividends (2002 to 2014, \$ in millions)**



**UMT Cumulative Cash from Operations vs. Cumulative Dividends Post Financial Crisis (2009 to 2014, \$ in millions)**



# MANAGEMENT LACKS CREDIBILITY

It appears that Deficiency Notes are used to obscure realized losses and to not recognize the losses in its income statement; the reliability of audited financial statements should also be questioned as this accounting treatment has been signed-off on for years.

- Approximately ten management insiders, through private entities, owe UMT shareholders \$73 million in the form of I-OWE-YOUs that were a result of realized (but unrecognized) financial losses.
- For the better part of a decade, management has not recognized actual realized losses in the financial statements (specifically the income statement) of UMT, a public company registered with the SEC.
- It appears that management has allowed a conflict of interest to manifest itself in the form of loans to UDF management and insiders, through their private entities, with interest rates far below a market rate.
- This is not only how UDF management operates UMT; it also appears to be consistent with how management operates UDF III and UDF IV – not recognizing losses incurred on non-performing loans.

# THE IMPLICATIONS FOR UDF IV

It appears that Deficiency Notes are used to obscure realized financial losses and to not recognize the losses in its income statement; the reliability of audited financial statements should also be questioned as this accounting treatment has been signed-off on for years.

- Hayman released a case study that highlights the irregular loan patterns related to UDF IV's largest borrower, Centurion American, including eleven specific examples that show loans (i) not generating any cash, (ii) accruing larger and larger balances for years and (iii) repeatedly being extended upon maturity.
- UDF management claims that "UDF IV has not had any realized losses."
- UDF IV has incurred losses but these losses have not yet been realized because UDF has not foreclosed on non-performing loans, which creates a misleading picture of the company's true financial condition.
- In this case study, we highlighted how UDF management has not recognized realized losses in UMT.
- In the case of UDF IV, UDF appears to have followed a similar path by not recognizing losses incurred on non-performing loans.
- Despite having already used UDF V to provide liquidity to UDF IV (which has helped distort the reality of UDF IV's true financial condition), it appears that the flow of new money into UDF V has just recently been shut-off, as UDF IV and UDF V's primary fund-raising mechanism, RCS Capital's broker-dealer, Realty Capital Securities, forfeited its broker-dealer license and filed for bankruptcy in January 2016.
- Typically losses are not realized until the flow of new money coming in runs out; that appears to be the situation that UDF III, UDF IV and UDF V are now facing.

