

FRIENDS IN HIGH PLACES
Anatomy of the SIC's Bad Investment in Earthstone International

A Report for the Rio Grande Foundation
by Jim Scarantino

Second in a Series

When it was seeking a \$9 million loan from the State Investment Council (SIC), Earthstone International said it was going to build a new plant in Santa Teresa that would create 200 jobs. Encouraged by this “pledge,” as Governor Bill Richardson called it, he urged the SIC to let Earthstone have the money. That was January 2004. Earthstone got the money, but the plant was never built.

A few months before, in August 2003, the SIC’s staff had said “no” to Earthstone. That denial was the result of due diligence and background investigation into Earthstone’s owners. Richardson, however, runs the SIC. He appoints the State Investment Officer. He controls the council that oversees the office’s operations.

In March 2004, Earthstone received \$5 million of the total loan amount, with the other \$4 million to follow. It promptly began breaking its contract with the SIC. It failed to pay interest on time. It misrepresented its assets. It was investigated by a Federal grand jury. The FBI has kept a file on the company, and New Mexico’s Attorney General has been asking questions about Earthstone as recently as October 2008.

Earthstone’s revenues today are almost 30 times lower than it projected when seeking the state loan.

Instead of building the Santa Teresa plant it pledged to build, it has exported jobs to Mexico and Arkansas. This happened, despite the fact that its contract prohibited establishing any manufacturing or similar facilities outside New Mexico until its new facility was built.

Nonetheless, Earthstone still got the other \$4 million of the loan. The \$9 million debt was effectively forgiven when it was converted to equity. And the SIC has continued to invest millions more in Earthstone and a subsidiary.

This is the second in-depth report by the Rio Grande Foundation into the state’s involvement with Earthstone. Our first report, “The \$9 million Loan to Earthstone International, or ‘A Funny Thing Happened on the Way to Santa Teresa,’” [www.riograndefoundation.org, 3/26/09], examined Earthstone’s failure to follow through on its pledge to build the Santa Teresa plant. It also pointed out Richardson’s political connections to Earthstone’s founders. This report and subsequent installments relate what has been learned after examining documents produced by the SIC in response to a public records request.

“Gay Seems to Know the Right People.”

Earthstone manufactures household cleaning products from recycled glass. It has a small plant in Santa Fe where it currently employs less than a dozen people. It was founded in 1993 by Andrew Ungerleider and his wife, Gay Dillingham. Ungerleider is an heir to the Gottesman paper and pulp commodity trading fortune.

Ungerleider likes to be known as the “granola bar king,” due to his past experience with a product known as Fi-Bar. That product was one of the first food bars to cross over from the health food niche into the mainstream economy. It reportedly once had annual sales approaching \$100 million. But Fi-Bar began to lose steam quickly and was later sold for a small amount to a Salt Lake City concern associated with health and fitness billionaire Joe Weider. Ungerleider told us that he received over \$20 million from the sale of his business. A source once closely associated with Fi-Bar told us that the company was essentially given away because its overhead was so large and its business had contracted so severely. Today, Fi-Bar is little more than a memory of its once prominent place in a booming new industry.

Dillingham is wealthy in her own right. She reportedly is an heir to an oil and gas fortune and has been a movie and television producer. She is entrenched in Santa Fe’s environmental activist and liberal establishment. She and Ungerleider have contributed over \$25,000 in the past seven years to Richardson and other Democrats.

In 2003, Dillingham was President of Earthstone. While Earthstone was asking the SIC for a multi-million dollar loan, Governor Richardson appointed her Board Chairperson of the New Mexico Environmental Improvement Board. As a July 15, 2003 e-mail in the SIC’s files states, “Gay seems to know the right people.”

When “No” Means “Yes”

The SIC staff and its advisers took a hard look at Earthstone and didn’t like what they found. They conducted a background investigation of the company’s leadership, scoured the company’s financial statements, and analyzed Earthstone’s business plan and projected growth. “After conducting due diligence,” Deputy State Investment Officer Deborah E. Gallegos wrote Earthstone’s CEO on August 14, 2003, “the State Investment Council has decided not to pursue an investment in Earthstone International LLC at this time.”

But only two months later, the SIC was negotiating the very same deal with Earthstone. On January 27, 2004, the SIC announced that it would extend Earthstone \$9 million in a convertible loan. Governor Bill Richardson took the credit. The SIC’s press release said the convertible loan was being done at the Governor’s “urging” because he was “encouraged” by Earthstone’s “pledge” to create 200 jobs at a brand new facility in Santa Teresa.

Documents in the SIC’s files reveal that promptly after being turned down by the SIC, Earthstone’s representatives began contacting other members of Richardson’s administration, particularly Rick Homans, who was then Richardson’s Economic Development Secretary.

Early Doubts behind the Scenes

Earthstone was going to be a huge deal—or so the SIC was led to believe. Only the rosier of pictures was shared with the public. Others in New Mexico’s venture capital community also bought into the hyperbole. “Earthstone is an excellent New Mexico success story with potential to become a significant driver in our economy in terms of job and wealth creation,” enthused Sherman McCorkle, President and CEO of Technology Ventures Corporation in a March 2004 press release.

According to a July 15, 2003 internal SIC e-mail, Earthstone was projecting 2009 revenues of \$69 million, up from \$4.8 million projected for 2003. But the same e-mail noted that Earthstone’s previous projections had been “optimistic.” It had previously projected \$19 million in revenues for 2003 and \$34 million for 2004. Earthstone’s “optimism” would surface again when its chief financial officer accused the company of inflating its gross revenues to meet a target that became a condition of the second round of financing from the SIC.

How “optimistic” was Earthstone in selling itself to the SIC? In an update provided to the SIC years later, Earthstone projected 2008 revenues of only over \$2.5 million and hoped to become “cash positive” in 2009.

Earthstone was also outwardly optimistic about construction of the pledged Santa Teresa plant. According to a press release announcing a unanimous vote by the SIC to approve the \$9 million convertible loan, Earthstone said construction of the plant would begin in 2004 or early 2005. While it was seeking the second installment of the loan, Earthstone’s CEO regaled SIC staff with reports of progress towards building the Santa Teresa plant.

Earthstone never even broke ground for the new facility.

More “Optimistic” Numbers From Earthstone

Earthstone received \$5 million of the loan in March 2004. According to the “Convertible Note Purchase Agreement” between Earthstone and the SIC, Earthstone would not receive the other \$4 million unless it met the milestone of gross revenues of \$4 million in a period of six consecutive months.

On December 9, 2004, Juan Peña, the Chief Financial Officer of Earthstone International, wrote a memo marked “confidential” to Scott Corriveau, Earthstone’s Chief Executive Officer. “Of great concern to me is the strong possibility that allegations of gross negligence and fraud could surface as a result of the business practices Earthstone has been involved in,” Peña wrote. “I wish to inform you of the difficulty to effectively and accurately execute my duties in an environment that overlooks those acts, which I find highly irregular, improper and unethical.” Peña went on to write how he had been directed to make entries in Earthstone’s books that inflated accounts receivable.

Peña’s confidential memorandum was discovered by auditors for the SIC and Earthstone’s own accountants. Earthstone was using the numbers that troubled Peña to show that it had met the milestone required by the SIC to release the second tranche of its \$9 million loan. The story found its way into the *Albuquerque Journal* in an article written by investigative reporter Thom Cole. As

Cole reported, while further investigation by auditors found no criminal misconduct, Earthstone's accounting practices were clearly very aggressive. For instance, it had been booking items sold on discount at full price, which greatly exaggerated its actual revenues.

In 2005, a federal grand jury subpoenaed the SIC's records. In what must have been an embarrassing moment for the SIC, it had to admit it could not locate the original loan agreement between the SIC and Earthstone. No indictment was returned. But years later, on March 21, 2007, the FBI requested additional information on Earthstone to "update the file." In early 2008, the New Mexico Attorney General's Office approached the SIC with questions about Earthstone. The AG made a follow-up inquiry on October 30, 2008. According to an internal SIC e-mail, "They [the AG] may also have an interest in the original investment process in 2003 as well."

The questions about Earthstone's bookkeeping were serious enough it was determined by the SIC's staff and outside advisers that Earthstone had not met the milestone required in the original loan documents. Furthermore, Earthstone was in default because it missed the first interest payment due September 2005. It was also discovered that Earthstone was in breach for not revealing liens on its intellectual property.

But by March 2005, the company got the rest of the \$9 million anyway. And recently, it has received nearly \$3.5 million more on top of the original loan amount. Our next installment will continue to follow the curious story of the SIC's involvement with Earthstone International.