INVESTIGATION: Secret Documents Reveal True Risks of 38 Studios

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A confidential investment memo obtained by GoLocalProv reveals in painstaking and dramatic detail the true risks of the 38 Studios venture back in 2009—in marked contrast with the highly optimistic picture that consultants and staff presented to board members of the state Economic Development Corporation one year later.

The document, technically known as a Private Placement Memo, was issued on May 1, 2009 by 38 Studios in a bid to secure $25 million in investment funds. The memo pulls no punches in describing the investment opportunity as "highly speculative and inherently risky." It warns that membership interests in the company should be purchased only by those "who can afford to lose their entire investment."

The longest section of the 37-page memo is devoted to spelling out 16 categories of risk—the unique unpredictability of the video game market, the challenges of launching in overseas markets, and the inherent risk in investing in a brand new company where the success of the venture rested on a few key individuals, to name a few.

"There is no guarantee of the economic success of any video game since the revenue derived from the production and distribution of a video game depends primarily upon the video game's acceptance, which cannot be predicted," the memo concludes.

(Click here to view a slideshow of excerpts from the memo.)

The memo is not mentioned in any of the meeting minutes or listed in any of the public documents the EDC has released regarding the deal with 38 Studios, the video game company founded by Red Sox star pitcher Curt Schilling.

Would memo have torpedoed deal?

"The worst part of this deal is that all of the risk—all of the risk—went to the taxpayer. If this document had come out at the time the deal … was being made there would have been an uproar," said Ed Mazze, business professor at the University of Rhode Island.

In contrast to that memo, the three public slideshows presented to the EDC board of directors in the summer of 2010 devote a total of just two slides out of 38 total to discussing the risks, which had been whittled down to four brief bullet points. (Click here and here to view two of the slideshows.)

And, in the space of two meetings prior to the vote approving the $75 million loan guarantee, the negative risks involved were discussed just twice.

Instead, the presentations from three consultants and EDC staff dwelled on the lucrative opportunities in a $72 billion global industry, which they predicted would nearly double by 2013. One after another slides flashed charts and other graphs showing the rapid growth in video game use among youth, U.S. subscriptions to massively multiplayer online games, and software sales as compared with hardware. One slideshow was devoted entirely to the hypothetical scenario of creating a cluster of video game companies in Rhode Island, with 38 Studios as an anchor.

‘Due diligence’?

In comparing the investment memo with the public presentations at the EDC meetings, it is clear that EDC board members—at least publicly—not only were not briefed on the full extent of the risks involved, but also that there were a number of additional risks that were not disclosed during the public board meetings.

“To me if you had a 30-slide show, perhaps 10 of them should have been on risk,” said state Sen. Ed O’Neill, an independent from Lincoln and a retired executive with Texas Instruments.

During his 35-year tenure with the company, O’Neill recalled his involvement in a number of complicated acquisitions, which he said required extensive due diligence. “We didn’t just peel the surface on those. We peeled 20 layers down to the core,” he said.

The confidential memo raised three questions for businessman Ken Block, the founder of the Moderate Party and a critic of the deal: Did the EDC staff even ask for the such documents from 38 Studios? Did 38 Studios provide them? And, if so, were those documents ever shared with EDC board members?

“The document you have contains a number of ‘boilerplate’ statements of risk that are standard for any such offering, the question is whether the EDC sought or prepared a comparable analysis of its proposed investment,” said state Rep. Laurence Ehrhardt, R-North Kingstown.

Such questions went unanswered by two spokeswomen for the EDC yesterday.

“I certainly don’t see anything referred to that in the minutes,” said Ehrhardt, who was a treasurer for a Fortune 500 company before his retirement. Consultant reports on the video game industry, he added, are “not the same thing as a detailed investigation of the company itself.”

Board members in the dark

In the summer of 2010, the membership of the EDC board, with few exceptions was comprised of heavy-hitting local business leaders—a hospital CEO, a Verizon regional president, the chairman of a top toy-maker and a senior executive at a construction company.

The risks listed in the confidential memo are common to the business and investment world, Mazze and Ehrhardt said. As experienced business people, EDC board members would have understood the general risks involved in the 38 Studios venture, Mazze said, but they “would not have understood how serious some of these risks are.”

The fact that such risks were minimized during the consultant presentations, Mazze added, made it that much easier for board members to ignore them. “I think they were a load of nonsense,” Mazze said, referring to the presentations, which were delivered by Wells Fargo, Strategy Analytics, and EDC staff. Mazze credited the prodding and “moral suasion” of the Governor and then-EDC Executive Director Keith Stokes with getting the board to approve the loan guarantee.

The type of investment the memo was seeking was riskier than the “secured debt” involved in the EDC deal, Ehrhardt added.

“However, if the collateral for the debt was the work product (the game being developed) all the warnings of risk would certainly apply to the potential value of the collateral (particularly in the event of failure) and argue strongly against assigning much value to the collateral thus rendering the statements of various people that the loan was safe because ‘it was secured’ absolutely unsupportable and meaningless,” he said.

Qualifications of board at issue too

The real issue, Mazze said, is the ability of board members to understand the risks involved and interpret the information presented to them. Having a member with banking experience would have been useful. A board member with investment experience—someone like state Treasurer Gina Raimondo, also would have been an asset to the board, O’Neill said.

O’Neill also questioned the qualification of the EDC staff, such as Stokes, who has a background in tourism, O’Neill noted. “Does he have the wherewithal to make an assessment on an investment like that? Probably not,” O’Neill said. “You need to have highly skilled, highly qualified people making these decisions.”

Efforts were made to reach every single member serving on the board in summer 2010. A handful were unavailable because they were traveling, but most simply did not respond to calls or e-mails requesting comments. Former board member Lynn Singleton, the head of PPAC, declined to comment and former board member Shivan Subramaniam, the CEO of FM Global, responded to a series of specific questions with this statement:

“Based on the information provided at the time, I voted along with the majority of the RIEDC board of directors in favor of the state supporting the project. Long term, the future of the Rhode Island economy must be built, in part, on developing a cluster of knowledge-based businesses and creating a qualified and well compensated local workforce that such enterprises demand.”

Messages left at the 38 Studios offices in Providence and Baltimore also were not returned.

Unsettling questions linger

Now, a week after 38 Studios declared bankruptcy, unanswered questions continue to pile up.

In 2010, EDC board members were assured that a third party would be monitoring 38 Studios and its progress. Two years later, O’Neill wonders why the bankruptcy came as such a surprise. “They should have known when the train was wobbling on the tracks," O'Neill said. "They didn't know until it was in the ditch."

"The whole process on this from beginning to end smells," Mazze said.

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