



BEFORE YOU GO IN-HOUSE: DILIGENCE!

A CASE STUDY



ABOUT THE AUTHOR

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ABOUT BANTAM INC.

Bantam Inc. (www.bant.am) is a private investment office for attorneys. We build custom, low-fee portfolios for attorneys with \$10+ million of investible assets. We also consult with clients on an hourly or fixed-fee basis without having to manage their assets.

Few firms can match Bantam's fiduciary commitment due to the simple fact that Bantam is a fiduciary twice over, once as a registered investment advisor and second as a New York State benefit corporation.

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INTRODUCTION

Surely every corporate attorney has been tempted by the siren song of generational wealth creation opportunities happening before their eyes at client firms. As well paid as top AmLaw firm attorneys are, their remuneration pales in comparison to the order-of-magnitude gains from equity appreciation at successful early- and growth-stage firms.

The problem is, that's only the *reward* part of the story. Risk comes first, reward after, and any evaluation of the risks of going in-house should clearly elucidate the risk/reward ratio.

For a typical AmLaw firm partner, the risk/reward ratio is low. There is high job security (low risk) and high compensation (high reward). For a general counsel at an early- or growth-stage firm, the risk reward ratio is high.¹ There is high job *insecurity* (high risk) and the compensation is binary - extremely high reward, or zero.

Indeed, an in-house position could be thought of as working for a law firm that has one huge contingency case. If the firm wins, there is a massive windfall for everyone, and if the firm loses, the firm is out of business.

In this case study I am examining an actual AmLaw 20 firm partner in-house move that went bad, to illustrate the importance of thorough due diligence.

I also show the significant benefits of having a third party assist with the diligence, as every successful attorney is busy and anyone seriously considering an in-house move is likely biased toward making the move. Busy and biased people don't always see the situation clearly or make the best decisions.

A CAUTIONARY TALE

Hong Liu ("Liu") was a partner in the New York office of Mayer Brown LLP. He had developed an active and successful transactional practice, representing well known clients in China and other parts of Asia.²

Mr. Liu was also highly educated, with a degree from Peking University Law School, an LLM from Harvard Law School, and an MBA from Oxford.³

In addition to being a successful law partner, Mr. Liu had served as General Counsel and Director-General of the China Securities Regulatory Commission, the national securities regulator of China.⁴ Thus, he was familiar with private firms going public, due diligence, and securities fraud.

In 2018, Mr. Liu left his law practice at Mayer Brown LLP to become general counsel at Faraday & Future Inc. ("Faraday"), a startup electric car manufacturer.⁵ After taking the position, Mr. Liu and his family moved to California.⁶ In January 2020, Mr. Liu filed a Complaint against Faraday alleging (among other things) fraudulent inducement and wrongful termination less than a year after Mr. Liu made the leap.

According to the Complaint, once at Faraday Mr. Liu tried to get management to focus on compliance and regulation.⁷ Evidently this was not welcomed, and Mr. Liu was fired for his efforts.⁸

On October 14, 2019, Faraday founder Yeuting Jia filed a petition for Chapter 11 bankruptcy in Delaware, listing some boldfaced firms as creditors, \$0.5 to \$1 billion in assets, and \$1 to \$10 billion in liabilities.⁹ The reorganization plan was approved on May 21, 2020.¹⁰ Faraday's operations were apparently halted pending the implementation of the reorganization plan.

Faraday has since announced its intention to IPO through a SPAC.¹¹



THE INDUCEMENT

Mr. Liu was a successful partner at Mayer Brown LLP with a \$1.35 million salary and significant retirement benefits.¹²

In order to induce Mr. Liu to leave his partner position at Meyer Brown LLP, Faraday offered a guaranteed \$1 million annual salary for five years and a guaranteed \$3 million signing bonus to be paid in \$600,000 installments over five years. However, this was basically a wash compared to Mr. Liu's \$1.35 million annual salary, plus retirement benefits (which were unspecified in the Complaint).

The real inducement was a grant of 20 million shares of Faraday, equal to two percent of Faraday's equity with a (theoretical) post-Series A valuation of \$90 million.¹³

RED FLAGS

Mr. Liu did undertake his own diligence into Faraday before the move, including asking about a critical Series A funding from Evergrande Health, a Chinese investment firm, that would give Faraday much-needed cash to fund its operations. The Complaint states:¹⁴

During these meetings, Mr. Liu repeatedly requested to view the Series A documents and attempted to inquire about the details of the Evergrande transaction. However, Mr. Jia and Mr. Wang refused to provide Mr. Liu with the relevant documentation and details of the Evergrande transaction, citing confidentiality obligations to Evergrande, but assured Mr. Liu that the Series A transaction was handled by reputable international law firms including Sidley Austin LLP and that Mr. Liu could be assured of the validity and quality of the transaction.

The Series A funding was critical because startups have little or no revenue and need constant outside investment to fund operations. It was also critical to the value of the stock compensation package offered by Faraday.

The post-money valuation of Smart King (the parent company of Faraday) was purported to be \$4.5 billion, so a two percent stake in Faraday was, in theory, worth \$90 million.

Faraday represented that it had closed the Series A funding of \$2 billion from Evergrande. In fact, Evergrande only invested \$300 million in Smart King on or about November 30, 2017, and only invested \$800 million in total by mid-2018 before terminating its relationship with Smart King.¹⁵

The fact that Mr. Liu could not verify the details of the Series A funding was a significant red flag. Indeed, the deal had been announced publicly, so there should have been no "confidentiality" issues, and if there were, Mr. Liu could have signed an NDA.

Another red flag was Faraday founder Yeuting Jia ("Jia") himself. Mr. Jia had serious regulatory issues in China prior to Mr. Liu's jump to Faraday. Indeed, in December 2017, The Wall Street Journal reported:¹⁶

This week, the Beijing First Intermediate People's Court seized 1.3 million yuan (about \$200,000) in Mr. Jia's bank deposits and ordered the seizure of 1 billion shares of LeEco's listed unit, Leshi Internet Information & Technology Corp., along with two properties that Mr. Jia owns in Beijing...

The court order and request for Mr. Jia's return follow a Shanghai court's decision in July to freeze \$181 million worth of Mr. Jia's assets and \$2 billion (worth of) shares of Leshi over a missed interest payment.

At the time Mr. Liu signed his contract with Faraday, Mr. Jia was a wanted man in China and had been put on a nationwide blacklist of debt defaulters.¹⁷ This information was publicly available. Either one of these red flags should have been a deal-killer. Taken together, they made the Faraday offer toxic.



RISK/REWARD ANALYSIS

Setting aside any fraud on the inducement, an objective analysis of the offer would have revealed certain asymmetric risks. While on the face of it, the salaries at Mayer Brown LLP and Faraday were a wash, they were not really comparable.

The Mayer Brown LLP salary was almost certain to be paid. The Faraday compensation was “guaranteed,” but only from continued employment or in the event of Mr. Liu’s termination, not if Faraday went out of business, which, in the world of startups, is the norm.

The Faraday offer needed to be discounted for the possibility of bankruptcy, a very real risk for even large startups. Indeed, only 50 percent of startups make it past their Series A funding round.

If we discount the \$1.35 million Mayer Brown LLP salary at five percent, and the \$1.6 million Faraday salary plus bonus offer at 50 percent, the five-year present values are \$5.9 and \$3.3 million, respectively.¹⁸ Conservatively, I have omitted the value of any Mayer Brown LLP retirement benefits from this calculation.

Thus, on a risk-adjusted basis, the Faraday offer represented a five-year salary haircut of \$2.6 million, which leaves the equity as the sole incentive for the move.

Applying the same 50 percent discount to the equity stake would reduce its discounted value to \$45 million.

In present value terms, trading \$2.6 million in cash flow over five years in exchange for the opportunity to pick up a \$45 million equity stake is not a bad trade. The problem with this is that if the firm fails, both the salary and the equity stake become worthless at the same time.

Because of this, de-risking the transaction takes on outsized importance. The way to de-risk any transaction is to undertake thorough due diligence.

DUE DILIGENCE

There’s an old saying that there’s no accounting for fraud, and to some extent that’s true. However, there are almost always red flags visible to those who look. Looking deeply is known as due diligence and the art of due diligence is blowing up the narrative.¹⁹

Any successful attorney working full time and contemplating going in-house is unlikely to have the time to properly diligence the hiring firm. This is true even if the attorney has worked for that firm for years as outside counsel.

ADDITIONAL DILIGENCE

There are many lines of questioning that could have been pursued on behalf of Mr. Liu, including:

- > Interviewing past Faraday employees;
- > Who was previous general counsel, if any?;
- > Why did he/she leave?;
- > Who was outside counsel?;
- > Could they be interviewed?;
- > Evergrande Health interview; and,
- > Examination of the Faraday balance sheet and cash flow statements.

Not all of these questions would be answered. However, the responses to the requests that Faraday would *not* answer would still be informative.



BENEFITS OF THIRD-PARTY DUE DILIGENCE

Separately, it pays to have an extra set of eyes on the documents, asking questions from a different perspective. This person or firm has a number of advantages, including:

- > Not being vested in the outcome;
- > Having no preconceived notions or opinions about the hiring firm; and,
- > Freedom to be a “bulldog” without jeopardizing potential future relationships.

CONCLUSION

Each potential deal will have its own contours based on the attorney contemplating the move, the hiring firm, and industry dynamics. For mid- and late-career moves that also impact an attorney's family, full diligence should be undertaken so that the risks and rewards are known as fully as possible and can be weighed accordingly.

Bantam offers a [full suite of consulting services](#) for attorneys contemplating an in-house move, lateral move, or other financially impactful decisions.

ENDNOTES



- 1 Of course, a jump to be general counsel of Google is different than a jump to a startup, so every offer is different.
- 2 Liu v. Faraday & Future Inc., (SDNY filed January 3, 2020); 1. Available at: <https://www.courtlistener.com/recap/gov.uscourts.nysd.529399/gov.uscourts.nysd.529399.1.0.pdf>; Accessed October 23, 2020. Hereafter “Complaint”.
- 3 Complaint at 4.
- 4 Complaint at 4.
- 5 Complaint at 1.
- 6 Complaint at 12.
- 7 Complaint at 13.
- 8 Complaint at 18.
- 9 Jia Yueting Voluntary Petition for Individuals Filing for Bankruptcy, (Delaware filed October 14, 2019). Available at: <https://dm.epiq11.com/case/yt1/documents>; Accessed November 16, 2020.
- 10 In Re: Yueting Jia; Order Confirming Third Amended Chapter 11 Plan of Reorganization for Yueting Jia (Dated March 26, 2020) as Modified, (California filed May 21, 2020). Available at: <https://dm.epiq11.com/case/yt1/documents>; Accessed November 16, 2020.
- 11 Catherine Shu; Faraday Future plans to go public through a SPAC deal; TechCrunch; October 6, 2020. Available at: https://techcrunch.com/2020/10/05/faraday-future-plans-to-go-public-through-a-spac-deal/?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAACoQP-8Gs_CfJF9ctZqs43p_yyN_FSz0rlwHdfseFc5TYA06qMsmx_Nn5sXvPBsnjVXDGbomdc1fKqjSvNmV1elimazxP7na5zNU6pc3RVlpWGM6hVuvXKaRzH1y8iVE8_3DsxCuXDtn2sF9pADT1t3uJzseo4i-IEwGhO5sdfk; Accessed December 23, 2020.
- 12 Complaint at 12.
- 13 Complaint at 8.
- 14 Complaint at 8. It’s not clear if Mr. Liu worked professionally with Faraday before becoming its general counsel.
- 15 Complaint at 9.
- 16 Alyssa Abkowitz; The Wall Street Journal; Chinese Court Seizes Assets of LeEco Founder; December 28, 2017. Available at: <https://www.wsj.com/articles/chinese-court-seizes-assets-of-leeco-founder-1514469249>; Accessed November 19, 2020.
- 17 Xie Yu; South China Morning Post; LeEco founder Jia Yueting receives financial lifeline from mystery Hong Kong investor; April 19, 2019. Available at: <https://www.scmp.com/business/companies/article/2142483/leeco-founder-jia-yueting-receives-financial-lifeline-mystery>; Accessed November 19, 2020.
- 18 Sebastian Quintero; Dissecting startup failure rates by stage; Journal of Empirical Entrepreneurship; November 7, 2017. Available at: <https://medium.com/journal-of-empirical-entrepreneurship/dissecting-startup-failure-by-stage-34bb70354a36>; Accessed December 22, 2020.
- 19 I get this phrase from Tom Brakke, the dean of investment due diligence. See The Investment Ecosystem™ Academy at: <https://academy.investmentecosystem.com/course?courseid=due-diligence-manager-selection>; Accessed December 23, 2020.



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*Note: Nothing in this case study should be considered individual investment advice.
If you need investment advice, please contact Bantam CEO Jack Duval.*

