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PUTTING SPACS ON THE SPOT – THE CASE OF NIKOLA MOTOR COMPANY AND ITS FORMER CEO

SPACs (Special Purpose Acquisition Companies) have exploded in popularity as an alternative method for companies to raise funds and become publicly traded. The recent boom in SPACs has attracted a tremendous amount of attention, not just from the investing public, but also US regulators. On July 29, 2021, the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) struck back at the SPAC phenomenon when they announced criminal and civil charges against Trevor Milton, the former CEO of the Nikola Motor Company. Nikola, which holds itself out as an innovative developer of alternative fuel trucks with zero emissions, went public by merging with a SPAC in June 2020. The charges filed in US federal court allege that Milton committed securities fraud by making false or misleading public statements about Nikola's products and technology to drum up investor demand in Nikola stock during the period leading up to and after its SPAC combination (known as the de-SPAC transaction). The case illustrates some of the regulatory enforcement and litigation risks surrounding the use of SPACs and demonstrates that mitigating these risks is important for parties to capitalize on the efficiencies offered by a de-SPAC transaction over a traditional IPO.

WHAT ARE SPACS?

SPACs are publicly listed corporate shells whose raison d'être is to combine with a privately held target company so that the target's stock may be publicly traded. SPACs have no underlying business operations and raise capital through an initial public offering (IPO) for use in acquiring a target company that is unidentified at the time of the IPO. A SPAC must identify and complete a business combination with a target company within a specified timeframe—usually within two years of

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the IPO—or face liquidation and the repayment of the IPO proceeds. Target shareholders may be cashed out, in whole or in part, by funds raised in the business combination. In the current SPAC market, however, it is typical that target shareholders only receive new shares in the combined company.

There were more than 380 SPAC IPOs in the first seven months of 2021 alone – an increase of over 1.5 times the same figure for all of 2020.[1] Proponents of SPACs argue that the structure allows for simplified valuation discussions between the SPAC sponsor and the target as compared to an IPO process. SPACs also may offer greater valuation predictability because the target can secure a valuation earlier in the process compared to an IPO— i.e., at the signing of the business combination agreement between the SPAC and the target, rather than at the pricing of an IPO. SPACs have also surged in popularity because they potentially allow private companies to go public faster than a traditional IPO and with fewer restrictions and customary hurdles. For this very same reason, de-SPAC transactions have attracted scrutiny from US regulators.

Critics of SPACs argue that their looser requirements weaken the guardrails of the traditional IPO process, exposing the investing public to heightened risk from weak disclosures or even false statements.[2] Notably, because the de-SPAC transaction is a business combination and not a public listing, the registration statement/proxies filed in connection with such transactions may include the target's financial projections, which are currently generally protected under a statutory safe harbor for forward-looking statements. This is in marked contrast to IPOs, where companies avoid making projections because the aforementioned safe harbor specifically does not cover false statements in IPO registration statements.[3] For many venture companies with little to no historical earnings, the ability to make financial projections is a key feature of SPACs.[4] According to one commentator, the SPAC rules give sponsors and target companies "greater freedom to tell their story" and this "regulatory loophole" helps explain their popularity.[5]

Moreover, de-SPAC transactions are not subject to the quiet period imposed on the going-public company in a traditional IPO that is mandated under Section 5 of the Securities Act. The quiet period generally prohibits the company from sharing any information outside its registration forms until sometime after the stock becomes publicly traded—usually 40 days. It is intended to protect investors by promoting a level playing field and preventing companies from pumping their stock price. Unconstrained by a quiet period, SPAC participants can (and often do) promote their stock to the investing public through mainstream and social media, employing, for example: "lengthy interviews with obscure YouTube channels

[1] *See* SPACInsider, SPAC IPO Transactions: Summary by Year (https://spacinsider.com/stats/)

[2] *See, e.g.,* https://www.wsj.com/articles/startups-going-public-via-spacs-face-fewer-limits-on-promoting-stock-11609678800?st=n60bq04ycbjxr8o&reflink=desktopwebshare_permalink; https://www.institutionalinvestor.com/article/b1qqvy1pqh34s6/Free-of-IPO-Constraints-SPACs-Can-Make-Absurd-Financial-Projections-And-This- Hedge-Fund-Manager-Says-The-Fallout-Is-Coming.

[3] Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k provides investors with the ability to hold issuers, officers, underwriters, and others liable for damages caused by untrue statements of fact or material omissions of fact within registration statements. Forward-looking statements made in connection with an IPO are excluded from the defense available under the statutory safe harbor for forward-looking statements under the PSLRA. See 15 U.S.C. §§ 77z-2, 78u-5.

[4] *See, e.g.*, https://www.nytimes.com/2021/02/10/business/dealbook/spac-wall-street-deals.html

[5] *See* https://www.bloomberg.com/opinion/articles/2021-01-28/why-chamath-palihapitiya-loves-spacs-so-much?sref=uC073IKU

frequented by individual traders, appearances on cable news, and projections that call for billions in revenue."[6]

The SPAC structure also raises the possibility of misaligned interests between the SPAC participants and the investing public. For example, SPAC sponsors and the target's executives are typically compensated by shares in the post-combination operating company. Although these shares are usually subject to a lock-up period, these periods are negotiated. The target's executives can sometimes demand a lock-up as short as 6 to 12 months, typically with a partial release if certain share price targets are met, which may not be enough time for investors to see the company's performance.

These potential risks for investors in SPACs, while by no means a comprehensive list, are highlighted in the case of Nikola and Trevor Milton.

THE CASE AGAINST NIKOLA AND ITS FORMER CEO

On March 3, 2020, Nikola announced that it would become a publicly traded company by merging with SPAC VectoIQ Acquisition Corp. The de-SPAC transaction was completed on June 3, 2020. In September 2020, the short-seller Hindenburg Research released a report accusing Nikola and Trevor Milton of perpetuating an intricate fraud by lying about the strength of its products and technology. Trevor Milton soon resigned. That same month, Nikola announced that it was under investigation by the DOJ and the SEC, and securities class-action lawsuits were filed against Nikola. By the end of 2020, Nikola's stock price had fallen more than four-fold from its peak in June 2020. In February 2021, Nikola disclosed that an internal review by an external law firm found that nine statements by the company or Trevor Milton were either wholly or partially inaccurate, but otherwise disagreed with the report by Hindenburg Research.

On July 29, 2021, the DOJ unsealed a criminal indictment against Trevor Milton in the Southern District of New York, charging him with two counts of securities fraud and one count of wire fraud.[7] That same day, the SEC filed a civil complaint in the same court, making similar allegations and charging Milton with violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[8]

According to the DOJ and the SEC, Trevor Milton engaged in an alleged scheme to defraud investors—in particular, non-professional "retail investors" or "Robinhood investors"—into purchasing Nikola stock.[9] Milton allegedly did this in the months leading up to and after the de-SPAC transaction by making false and misleading statements about the strength of Nikola's business— among other things, the development of its electric and hydrogen trucks, hydrogen and battery technology, and the number of committed orders.

In a sign of the times, Milton's alleged misstatements were primarily made through social media and podcasts, and the DOJ indictment noted that many of the retail investors "had no prior experience in the stock market and had begun trading

[6] https://www.wsj.com/articles/startups-going-public-via-spacs-face-fewer-limits-on-promoting-stock-11609678800
[7] *United States v. Milton*, 21 Cr. 478 (SDNY).
[8] *United States Securities and Exchange Commission v. Milton*, 21 Cv. 6445 (SDNY). The SEC complaint against Trevor Milton makes similar allegations but offers more detailed factual content.
[9] DOJ Indictment ¶ 22, 26; SEC Complaint ¶¶ 1, 3, 43.

during the COVID-19 pandemic to replace or supplement lost income or to occupy their time while in lockdown."[10]

Significantly, the DOJ indictment paid specific attention to the SPAC process for Nikola and how retail investors were disadvantaged. In particular, the allegations highlight that SPACs are not subject to the quiet period that constrains company executives in a traditional IPO.[11] The absence of a quiet period for de-SPAC transactions seems to be a lens through which the DOJ views the case—of note, the indictment alleges that quiet periods help promote "fairness in the market and protect retail investors" by "ensuring that all investors have the same access to information at the same time" and preventing executives from "hyping or inflating the stock price."[12]

According to the DOJ press release, Milton "took advantage" of the fact that Nikola went public with a SPAC combination "by making many of his false and misleading claims during a period where he would have not been allowed to make public statements under rules that govern IPOs."[13] Because Milton was not subject to a quiet period, he was able to immediately promote Nikola to retail investors after the going-public announcement was made on March 3.[14] This was allegedly part of a concerted plan by Milton to get "retail investors on our side" because he believed "[t]hat is what prevents the stock short selling." Milton allegedly touted the ability to directly communicate with the investing public as a benefit of Nikola going public by SPAC—he could "communicate with the market," instead of "bankers . . . trying to tell people what your company is like. . ."[15]

The issue of compensation for company executives in connection with de-SPAC transactions and the use of lock-up periods also features prominently in the allegations. Milton allegedly negotiated a compensation scheme with VectoIQ and its shareholders that gave him carve-outs to his one-year lock-up obligation: Milton was allowed to sell back to Nikola $70 million in shares once the combination was consummated, and to sell another $70 million in shares six months after the combination.[16] Moreover, after completion of the business combination, Milton allegedly negotiated a further amendment that reduced his overall lock-up period to six months.[17]

Notably, although the DOJ is not known to have charged Nikola, the VectoIQ sponsors, or anyone else in connection with this case, the indictment alleges that certain Nikola investors had an advantage over retail investors: "early strategic investors, VectoIQ shareholders, and PIPE investors who had invested prior to the completion of the business combination between Nikola and VectoIQ had access to more complete and accurate information during their prior due diligence periods." These investors allegedly "had access to more complete information regarding Nikola's products and technology were able to sell their stock for a

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10 DOJ Indictment ¶ 3.
11 DOJ Indictment ¶¶ 10-12.
12 DOJ Indictment ¶ 10.
13 https://www.justice.gov/usao-sdny/pr/former-nikola-corporation-ceo-trevor-milton-charged-securities-fraud-scheme#_ftn1
14 DOJ Indictment ¶ 25.
15 DOJ Indictment ¶ 24. The SEC Complaint does not discuss the issue of a quiet period.
16 DOJ Indictment ¶ 19; SEC Complaint ¶¶ 160-61.
17 DOJ Indictment ¶ 20; SEC Complaint ¶ 162. The SEC's allegations provide additional detail regarding Milton's compensation structure and his effort to reduce his lock-up period, including that Milton told a member of Nikola's board of directors that he should be released from the lock-up because he had delivered "over 400% gain" to share price, making "everyone else millionaires and billionaires." SEC Complaint ¶ 161.

significant profit" while many retail investors were purchasing Nikola stock based on Milton's false and misleading statements.

The DOJ and SEC charges against Trevor Milton are merely allegations at this stage. He has pleaded not guilty to the indictment.

IMPLICATIONS

The criminal and civil charges against Trevor Milton are the most aggressive charges in connection with a de-SPAC transaction that the DOJ or the SEC have brought to date. The facts alleged against Milton are not representative of most de-SPAC transactions. Even so, they reflect the potential regulatory pitfalls in de-SPAC transactions and the types of issues that the DOJ, the SEC and other regulators are on the watch for. They send an unmistakable signal that the DOJ and the SEC are serious about addressing the risks to the investing public associated with SPACs and will not hesitate to bring charges if they believe the evidence supports them.

In particular, the DOJ explicitly called out the features of the Nikola de-SPAC transaction that allegedly increased the risk of securities fraud: (i) the lack of a quiet period facilitated Trevor Milton's alleged scheme to defraud investors by allowing him to make false or misleading statements to drum up demand for Nikola stock in the run-up to consummating the combination, and (ii) Milton's compensation scheme with the lucrative carve-outs from the lock-up periods that he negotiated with VectoIQ and its sponsors incentivized his scheme by allowing him to quickly cash out.

These will likely be areas that regulators will focus on, and securities class-action plaintiffs will too. SPACs and target companies should always diligence their public statements, especially about projections or prospects, to ensure they are reasonable and supportable. Such diligence will be even more important during the sensitive time around the combination that would otherwise be covered by the quiet period in a traditional IPO. Demanding that targets produce comprehensive and high-quality disclosures can help mitigate the risk that statements by their executives or representatives might be deemed false or misleading after the fact. SPACs and their target companies should also be sensitive to the terms of compensation for target management and shareholders. For example, lock-up periods should be appropriately calibrated to signal that their long-term economic interests are aligned with those of the company and its public investors.

Moreover, the DOJ allegations regarding how retail investors were disadvantaged vis a vis earlier investors in the SPAC that profited from the rising price of Nikola stock, indicate that regulators will be attuned to the specter of insider trading around de-SPAC transactions and the quality of due diligence performed by SPAC participants. These earlier investors allegedly had access to better information about Nikola's products and technology and were presumably better placed to assess the validity of Milton's statements about Nikola. Regulators will actively investigate such issues even if no charges are ultimately brought. Accordingly, SPACs ought to be proactive in implementing risk mitigation strategies to guard against insider trading, including ensuring that policies and procedures are reasonably designed to prevent the misuse of material nonpublic information.

Regulatory scrutiny of SPACs will continue. For example, the SEC recently settled an enforcement action against the SPAC known as Stable Road Acquisition Company, its sponsor, the target company Momentus, and the respective CEOs, in connection with misleading disclosures ahead of the de-SPAC transaction. SEC Chair Gary Gensler said the case "illustrates risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors."[18] The SEC found that the SPAC, its sponsor, and its CEO had been negligent in conducting due diligence of the target, and that the target and its CEO had withheld information from the SPAC and caused the SPAC's violations.[19] With the exception of the target's CEO, who is contesting the SEC's charges, the remaining respondents collectively settled the action by agreeing to a civil penalty of approximately $8 million and other equitable relief.

Other investigations involving SPACs or their post-combination operating companies are ongoing. Lordstown Motors, another troubled developer of low-emissions alternative fuel vehicles, recently disclosed that the DOJ (the same US Attorney's Office prosecuting Trevor Milton) and the SEC were examining its combination with the SPAC DiamondPeak Holdings and its vehicle preorders.[20] Like Nikola, Lordstown had been the subject of a short-seller report by Hindenburg Research earlier this year. In June 2021, Lordstown contested many of the allegations by Hindenburg Research, but disclosed that an internal investigation had identified "issues regarding the accuracy of certain statements regarding the company's preorders."[21]

CONCLUSION

It remains to be seen whether and how the charges against Trevor Milton will affect SPAC activity. Nevertheless, the continued regulatory scrutiny on de-SPAC transactions means more prosecutions and enforcement actions are likely. In turn, this will fuel private securities litigation against SPAC-related entities and their directors and officers arising from alleged fraudulent or misleading statements. Accordingly, SPAC market participants should take a proactive and common-sense approach towards risk mitigation—the US securities laws still apply whether it is a de-SPAC transaction or a traditional IPO, and fraud is still fraud. While the allegations against Trevor Milton might be an egregious example of what could go wrong in a de-SPAC transaction, they underscore the hazards of complacency for SPAC market participants.

A de-SPAC transaction may offer advantages to a traditional IPO, but they are not a shortcut for diligence and compliance. SPAC participants (sponsors, target companies, and their advisors and bankers) should prepare well and early for the intense scrutiny that follows publicly traded companies.

[18] https://www.sec.gov/news/press-release/2021-124
[19] https://www.sec.gov/litigation/admin/2021/33-10955.pdf
[20] https://www.law360.com/articles/1403953/lordstown-motors-says-doj-probing-spac-deal-pre-orders
[21] https://investor.lordstownmotors.com/news-releases/news-release-details/lordstown-motors-reports-results-special-committee-investigation

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