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4 Public Co. Lessons From Nikola Founder Fraud Conviction

By **Edward Imperatore** (November 2, 2022, 3:03 PM EDT)

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Last month, a federal jury in the U.S. District Court for the Southern District of New York convicted Trevor Milton, the founder and former chief executive officer of the electric carmaker Nikola Corp., following a criminal trial on three of four counts of securities and wire fraud against Nikola investors.

Although the case arose in the context of a special purpose acquisition company, it highlights practical lessons for public companies beyond the scope of SPACs, including:

- The limits of aspirational statements and puffery in the context of investment solicitation and a defense of reliance on other corporate actors;
- The importance of internal controls to vet public statements, including on social media and podcasts, to ensure their accuracy;
- Structuring executive compensation to align executives' interests with those of shareholders; and
- The significance of the ordinary or retail investor in assessing the materiality of public statements.

Background

In U.S. v. Milton, the prosecution presented a relatively simple and straightforward theory for a criminal case alleging disclosure fraud by a public company. The government alleged that Milton had made misrepresentations to the public, including in interviews and on social media, about Nikola's product development and technology to induce investments in the company.

Milton allegedly misrepresented, for example, that Nikola's electric trucks were functional when in reality they did not work, and that Nikola had binding purchase orders that did not really exist. The prosecution therefore applied a basic and traditional theory of securities and wire fraud — lies to obtain investments — in the novel context of a SPAC transaction.

The case thus turned on a basic issue: whether the defendant intended to deceive investors when he

spoke about Nikola's products.

In 2020, Nikola listed on the Nasdaq Stock Market by merging with a SPAC. Evidence showed that Milton decided to offer Nikola's shares to the public through a SPAC combination, known as a de-SPAC transaction, rather than a traditional initial public offering, in part because it allowed him to speak openly to investors.

De-SPAC transactions are not subject to the quiet period required by Section 5 of the Securities Act for companies going public in an IPO. The quiet period in an IPO prohibits a going-public company from disclosing information other than its registration statement and prospectus until after the stock begins trading.

The purpose of the quiet period is to ensure that all investors have the same access to information at the same time and to foreclose certain activity that could inflate the stock price.

Unrestricted by a quiet period, Milton launched a campaign to promote Nikola in online interviews and on social media. Through the SPAC, Milton also negotiated a compensation package that allowed him to sell back to Nikola $70 million in shares upon the SPAC combination and an additional $70 million in shares six months after the combination.

Jurors' Account of Deliberations

Two weeks after the verdict, The Wall Street Journal published an article in which three jurors, including the foreperson, described the jury's deliberations, which resulted in convictions on counts of securities fraud and wire fraud, but an acquittal on another securities fraud count involving the same theory and conduct.[1]

Jurors expressed doubt about whether Milton had acted with criminal intent, and their account shows that the jury may have misunderstood the legal instructions.[2] While the defense's ability to challenge the verdict based on the Journal article is limited,[3] the jurors' account could cloud the verdict and cast doubt on what the jury found.

Lessons Learned for Public Companies

Notwithstanding the jurors' account of deliberations, U.S. v. Milton highlights for public companies (1) the limitations of defenses based on aspirational statements and reliance on other corporate actors; (2) the need for internal controls over public statements; (3) the importance of structuring executive compensation to align stakeholders' incentives; and (4) the significance of the retail investor.

1. The Limits of Aspirational Statements and Claims of Reliance on Other Corporate Actors

Like the trial conviction of Theranos Inc. founder Elizabeth Holmes, Milton's trial reflected the limitations of two defense themes that are increasingly present in securities fraud trials of corporate executives: (1) aggressive, aspirational sales tactics, particularly in the context of startup companies; and (2) a defense argument of reliance on other corporate employees.

Milton's statements to the investing public, memorialized on social media and in podcasts, were not disputed at trial. The questions for the jury were (1) whether Milton's statements were false, and (2) whether Milton acted willfully and with intent to defraud.

In broad strokes, Milton argued that he believed in good faith that what he was saying was true and did not intend to deceive investors. He also argued that he had reason to believe that his vision of Nikola's products and sales would ultimately come true.

Central to the dispute over Milton's state of mind were his interactions with Nikola employees. The government portrayed Milton as a lone actor who crafted public statements without the approval of others and ignored red flags raised by his staff.

For example, the government placed weight on testimony that senior executives had a so-called intervention with Milton in which they urged Milton to curb his social media practices. In response, Milton argued that he relied in good faith on his executive team and that no one warned him at the time that his statements were false.

Both the Holmes and Milton trials sought to define the line between, on the one hand, aggressive sales tactics involving puffery or an aspirational vision of a startup company and, on the other hand, intent to deceive investors.

As in the Holmes trial, the U.S. v. Milton jury apparently found that Milton misrepresented his company's products and technology and rejected a defense argument that he made good-faith, forward-looking statements.

The jury likely credited evidence that Milton disregarded concerns that Nikola employees had raised with him about his public remarks. The result reflects the limitations of a defense advanced by a senior executive of reliance on other corporate actors.

Thus, following Holmes' conviction, the U.S. v. Milton verdict demonstrates the perils of fake-it-till-you-make-it sales tactics and aspirational statements made by executives to solicit investments.

2. The Need for Internal Controls Over Public Statements

U.S. v. Milton highlights that whenever executives speak to the investing public, they are exposed to potential scrutiny from regulators and criminal authorities. The securities laws apply equally to social media and more traditional forms of investor communications, including earnings calls, earnings reports and press releases.

Although Milton argued to the jury that social media and podcasts were not a platform for a securities fraud scheme, the jury concluded otherwise.

In fact, recent cases suggest a trend toward increased government scrutiny of social media posts, including celebrity touting of cryptocurrency tokens and the use of social media to engage in market manipulation or investment fraud.

The U.S. Securities and Exchange Commission likewise made clear that Regulation Fair Disclosure, which is designed to prevent public companies from making selective disclosure of material nonpublic information to securities professionals or shareholders before it is made to the general public, "is equally applicable to current and evolving social media channels of corporate communication" and that "the investing public should be alerted to the channels of distribution a company will use to disseminate material information."[4]

From U.S. v. Milton emerged a picture of a startup company that was unprepared to fulfill its obligations to investors and lacked sufficient internal controls to ensure that comprehensive and accurate information was disclosed to the public in interviews and on social media.

U.S. v. Milton thus underscores two related forms of internal controls that public companies should implement.

First, companies must ensure that executives who speak to the investing public are provided with accurate and up-to-date business information. This is particularly important when executives, like Milton, speak about product development and technology, which are constantly evolving for a prerevenue startup company.

Second, companies should implement a protocol for vetting public statements to ensure their accuracy, including statements made in interviews and on social media. Like earnings calls and press releases, social media posts and talking points for podcasts and other interviews should be reviewed and vetted carefully by a team of professionals, including lawyers, accountants, and product development and investor relations personnel.

Those procedures should provide a means for professionals to comment and raise concerns before the statements are finalized and ensure that statements are disclosed fully to the public, as required by Regulation FD.

3. Structuring Executive Compensation to Align Incentives

Companies should also evaluate the incentives created by executive compensation plans. Milton's compensation structure, which allowed him to sell his shares quickly without a lock-up period restriction, placed his economic interests at odds with those of Nikola's shareholders. The structure arguably incentivized him to inflate Nikola's stock price by misleading the investing public until he sold his shares.

A company's compensation program should seek to align executives' incentives with the long-term interests of the company and its shareholders. In fact, the U.S. Department of Justice recently announced that its evaluation of corporate criminal resolutions will take into account whether a company's compensation program "reward[s] compliance and impose[s] financial sanctions on employees, executives, or directors whose direct or supervisory actions or omissions contributed to criminal conduct."[5]

4. Materiality — Focus on Retail Investors

To prove securities fraud and wire fraud, the prosecution was required to demonstrate that Milton's alleged misstatements were material, meaning that they were important to a reasonable investor in making investment decisions. At trial, the parties clashed over what it meant to be a reasonable investor and disputed whether Milton's statements mattered to a reasonable investor in deciding whether to buy or sell Nikola shares.

The most complex public company cases typically involve allegations of accounting fraud, often focusing on inflation of earnings or other financial metrics disclosed in a company's public filings that sophisticated institutional investors and analysts monitor. Milton, by contrast, targeted nonprofessional,

retail investors, many of whom were unsophisticated and lacked investment experience.

The government called as witnesses two retail investors who had followed Milton's podcasts and social media posts. Those witnesses testified that Milton's statements about the development of Nikola's products were important to them in deciding whether to invest.

Milton sought to undermine the retail investors' accounts by showing that they had failed to consider the total mix of information in the market. To rebut the government's materiality evidence, Milton also called an economist as an expert witness to testify that Nikola's stock price did not react to Milton's alleged misstatements.

It appears that the jury was unpersuaded by the defense's arguments and credited the retail investors' testimony in finding that Milton's statements were material.

U.S. v. Milton thus elevates the retail investor in the materiality assessment and underscores for public companies that statements about product and technology development, including on social media, can be material.

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[1] Corinne Ramey, Inside a Jury's Five-Hour Journey to Convict Nikola's Trevor Milton, Wall St. J. (Oct. 27, 2022), https://www.wsj.com/articles/inside-a-jurys-five-hour-journey-to-convict-nikolas-trevor-milton-11666863002?reflink=desktopwebshare_permalink.

[2] Id.

[3] Federal Rule of Evidence 606(b) provides that "a juror may not testify as to any matter or statement occurring during the course of the jury's deliberations . . . or concerning his mental processes in connection therewith…. ." See Ohanian v. Avis Rent A Car Sys., Inc., 779 F.2d 101, 110 (2d Cir. 1985) ("It is well established that evidence from a jury or juror may not be used to impeach the jury's verdict."); see also United States v. Pierce, 940 F.3d 817, 822-23 (2d Cir. 2019) (rejecting defendant's "challenge to jury verdicts that were inconsistent as to different counts").

[4] Press Release, SEC, SEC Says Social Media OK for Company Announcements if Investors Are Alerted, SEC Press Release No. 2013-51 (Apr. 2, 2013), https://www.sec.gov/news/press-release/2013-2013-51htm.

[5] Deputy Attorney General Lisa O. Monaco Delivers Remarks on Corporate Criminal Enforcement, U.S. Dep't of Justice, https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement (last updated Sept. 23, 2022).