An Insight into the World of SPAC Fraud

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Abstract: A special purpose acquisition company (SPAC) is an alternative way to take a company public and avoid the traditional initial public offering (IPO) route. It has no business model or commercial operations: it is to raise capital to acquire or merge with an existing company, known as a "blank check" (Chen). SPACs are nothing new to the public markets, but the SPAC world has surged over the last two years. For example, in 2020, $80 billion was invested into 247 SPACs, and in the first quarter of this year alone, $96 billion was invested into 295 SPACs (Chen).

The research in this paper revolves primarily around two SPAC transactions that occurred in 2020. Nikola (NASDAQ: NKLA) and Clover Health Investments (NASDAQ: CLOV) were two of the biggest SPACs to become public in 2020 and consequently are both currently undergoing fraud investigations conducted by the Securities and Exchange Commission (SEC) and Department of Justice (DOJ). The insight will be provided into both business models, their founders, and the severity of their respective investigations by short-seller Hindenburg and the DOJ.

Ultimately, these investigations will be connected to other significant SPACs that have been accused of fraudulent business operations by comparing them to what happened with reverse mergers in 2011-2012. The lack of morality from reverse mergers resulted in the SEC posting a bulletin that warned investors to be cautious when investing in such companies, noting that they are risky investments.

The Big Three: IPOs, Reverse Mergers, and SPACs

Traditionally, companies can decide to become publicly traded through the initial public offering process (IPO). An IPO allows companies to raise capital and funds from public investors after transitioning from being private. However, to successfully go through the IPO process, the company must meet the Securities and Exchange Commission (SEC) requirements. The IPO process contains two parts and eight steps. The two parts consist of a "pre-marketing phase" and the IPO itself (Fernando). Companies must present proposals and valuations of their services and hire underwriters and an IPO team complete the necessary documentation for S-1 Registration and public filings. Once those steps have been completed successfully, the company forms a board of directors, sets up a financial audit process to provide to the SEC every quarter, and is then allowed to issue shares on an IPO date. The IPO process is the norm but is very time-consuming and costly, leading to other avenues being created to take a public company.

Enter the reverse merger era. Instead of going through SEC and S-1 filings, a reverse merger already had an existing "shell company" that was public but had no operations. This allowed the company to acquire a private firm with a legitimate business model. In addition, reverse mergers were much faster and cheaper than IPOs, and the shell company was only required to report a Form 8-K filing with the SEC without the registration requirements of an IPO. This money through the public markets at little cost, which sounds ideal. Unfortunately, that was not the case with reverse mergers, which fell off after the SEC posted an investor bulletin in 2011 cautioning investors about buying into companies that went public via reverse merger. This was done to prevent investors from putting money into reverse mergers and encourage more due diligence on the investor's end. In today's market, SPACs are taking over, and some SPAC companies are running into similar problems that have been seen before in the reverse merger era.

An Overview of the Transactions

Nikola

Nikola Corporation, as stated on the company's website, is "a leading designer and manufacturer of heavy-duty commercial battery-electric vehicles (BEV), fuel cell electric vehicles (FCEV), and energy infrastructure solutions." The business model allows consumers to integrate hydrogen fueling infrastructure into truck technology and take steps to bring electric vehicles (EVs) to the next generation (Milton). Unfortunately for Founder, Trevor Milton, has a history of shady business dealings tracking all the way back to when he dropped out of college after one semester and started his first 'green-friendly' vehicle business. Milton had previously founded two alternative EV companies however both ended poorly before founding Nikola Motors. Nikola was founded in 2015 and, in June 2020, was taken public via Reverse Merger SPAC with VectoIQ (blank-check).

Milton's Undeserved Accomplishments

In September 2020, Nikola and General Motors announced a strategic partnership that would begin with the Nikola Badger truck and incorporate cost reductions for several Nikola Programs. In addition, the agreement would have Nikola utilizing GM's Ultium battery system and Hydrotec fuel cell technology, which would represent "a key commercialization milestone for General Motors" (Barnas). Milton boasted to the media about the partnership, resulting in the stock price booming to nearly $60 per share for a company that had not yet made even one vehicle delivery. Milton said, “We made three promises to our stakeholders and have now fulfilled two out of three promises ahead of schedule. What an exciting announcement,” a statement that would soon become ironic for Milton (Barnas).

The Hindenburg Research Report

Founded by Nathan Anderson Hindenburg Research is an investment research firm that acts as a short seller specializing in forensic financial research. The Hindenburg team dropped a bombshell report on Nikola and Milton, beginning with an assertion saying, “Today, we reveal why we believe Nikola is an intricate fraud built on dozens of lies throughout its Founder and Executive Chairman Trevor Milton’s career.” (Hindenburg Research). The report detailed with evidence of recorded phone calls, texts, emails, and pictures of the misinformation that Milton spread regarding Nikola, would ultimately force Milton to resign from his position at the company. One of the first accounts of deception was Nikola’s semi-truck promotion in which they filmed a video of their semi-truck “towed to the top of a hill on a remote stretch of road and simply filmed it rolling down the hill” (Hindenburg Research). The truck never actually worked because the company never truly had a battery for their vehicles. Nikola was supposed to acquire a vaporware tech battery, but that company had legal issues. According to the report, a representative from Volvo said that Nikola’s hydrogen fuel cell battery was “hot air.” Important details from the report involved Milton’s claim that “Nikola designs all key components in-house,” which was blatantly false. All of Nikola’s vehicle components were bought from third parties or licensed. This was proven when Nikola was caught covering Cascadia, an inverter company’s label, with masking tape. Through emails and interviews with former Nikola employees and partners, Hindenburg found that Milton had artists stencil “H2” and “Zero Emission Hydrogen Electric” on the Nikola One even though the vehicle had zero hydrogen power or capability: it was natural gas (Hindenburg Research). Besides these points, more evidence in the report reflects Milton’s shady operations, unethical business procedures, and most likely more the team did not encounter in their investigation.

Clover Health Investments

Clover Health Investments is a Preferred Provider Organization (PPO) and a Health Maintenance Organization (HMO) with a Medicare contract. Vivek Garipalli founded the company in 2014. Clover is Garipalli’s, who formerly founded Carepoint and a revenue cycle company called Ensemble Health. third healthcare service company. Garipalli owned three New Jersey Hospitals through CarePoint Health and was notorious for charging the highest prices for emergency room treatments in the nation. New Jersey local media reported that one of his hospitals charged a schoolteacher $9,000 for a finger bandage and a tetanus shot (Hindenburg Research-Clover). In the company’s “Meet Clover Health” video, Garipalli explains the Clover Health system’s purpose is to "drive net improvement in decision making for physicians" (Baxter-Still). With an admirable company goal and vision, celebrity investor and former Facebook executive, Chamath "SPAC King" Palihapitiya, took a likening to the company and provided funding to take Clover Health public by merging with one of his six Social Capital blank check companies. Social Capital would provide the capital and act as the shell company that Clover would merge into to become public. Clover Health debuted on the Nasdaq Exchange on January 8th in a $3.7 billion deal. Since then, the company has run into many fraudulent issues, of which several stem back to Palihapitiya's wrongdoings.

The SPAC King's Influence

When talking about the stock market, Chamath Palihapitiya is one of the most influential. He is a billionaire, part-owner of the Golden State Warriors, and has nearly two million Twitter followers, his own hit podcast, and a massive audience of retail investors who follow his every move. When pitching Clover Health to the public, he said that Clover Health's revenue would triple in less than two years. He also aligned his "best interest" with the investors, saying, "There is no way that I can win unless the stock goes up… This is not some get-rich-quick scheme, at least for me." With such words coming from a celebrity, a casual investor can only imagine the money they could be making by investing in the company (Enomoto). But as always, there was a catch and a way that Palihapitiya would be profitable from his investment regardless of how the stock performed. In a SPAC deal, the sponsor (in this case, Social Capital) keeps 20% of the stock as a fee. Since, it is not a traditional IPO, the company can make any financial projections they would like since there is no regulation of the kind on SPAC acquisitions. The latter allows a sponsor or the business itself to exaggerate future performance and ambitions for the company to any extent as Palihapitiya did when pitching the business. Throughout these claims, the SPAC King failed to mention DOJ investigations, where Clover's actual sales are coming from, and an undisclosed company subsidiary.

Hindenburg Catches Another SPAC

Hindenburg's report on Clover Health is targeted at Chamath and how he misled investors about "critical aspects" of Clover Health's business (Hindenburg Research-Clover). The short seller had been investigating the company for four months before publishing their report. The most significant part of the investigation was the DOJ's investigation into Clover Assistant, the software Clover Health's business model uses. The DOJ investigation included twelve separate issues dealing with undisclosed third-party deals, bribes, and foul-play marketing practices (Enomoto). These investigations are hazardous to a company that receives a large amount of revenue from government payments due to providing Medicare. Another standout point from the report was Clover Health's "independent" subsidiary, Seek Insurance. When questioned, representatives of Seek claimed that "it doesn't work for the insurance companies but rather for the customer." (Enomoto). The claim makes no sense as it is owned by Clover Health, an insurance company that led Seek Insurance to be found under DOJ Investigation. To continue with the eye-raising claims, a former Clover Health estimated that nearly 68% of Clover Health's total sales came from a third-party brokerage firm controlled by Hiram Bermudez, the company's Head of Sales. According to Bermudez, he put his wife's name in the insurance filings for "compliance purposes" (Hindenburg Research-Clover). The CEO, Vivek Garipalli, prompted that physicians love using Clover but failed to mention that it is because they pay them extra to use the platform. Physicians were compensated $200 to use the Clover Assistant software, which is nearly twice the average reimbursement rate for a Medicare visit. Doctors that were interviewed for the report said that the software was a waste of time and a hassle. Knowing Garipalli's history during his CarePoint days, it is no wonder that Chamath called him "an absolute proven moneymaker." Social Capital received over 20 million "founders shares" for a mere $25,000 to promote Clover Health. The founder shares he received will ensure that Chamath will be highly profitable from his investment regardless of stock performance.

The Morley-Jackson Lawsuit

Because of the Hindenburg reports and DOJ investigations, Nikola and Clover Health are not the only SPACs facing legal consequences and company turmoil. New York University Professor Robert Jackson, former commissioner of the SEC, and Professor John Morley of Yale filed a lawsuit against the world's largest SPAC. The suit brought against billionaire hedge-fund investor Bill Ackman and his SPAC, Pershing Square Tontine Holdings (PSTH), contends that the SPAC is an investment company, not an operational one (Sorkin). If Jackson and Morley are correct, Ackman's SPAC would be violating the Investment Company Act of 1940, and in that case, many other SPACs could be affected by the same ruling. GOAcquisition and E.Merge Technology Acquisition Corp were also filed in the lawsuit. Morley and Jackson have significant backing in the case filing, with co-counseling from Susman Godfrey, Bernstein Litowitz Berger & Grossman, and RM Law. The Investment Company Act of 1940 "regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public" (Roisman). Morley and Jackson's theory is that SPACs that fail to acquire an operating company within a year of public share offering must be held under the act's regulation. Ackman had negotiated a deal between PSTH and Universal Music Group in which Pershing would buy a 10% stake in the company for $4 billion, but the company was already being taken public by the parent company, Vivendi. This made the SEC question Ackman's deal, and he later abandoned it, writing a letter saying he "underestimated regulatory and shareholder resistance to the complex transaction" (Sorkin). The Morley-Jackson suit seeks to ask the court to declare PSTH as an investment company, to find it was mischaracterized to avoid legal requirements, rescind board member's contracts, and has the goal of making SPAC founders wary of legal consequences and preventing loopholes in the future.

Digital World, the SEC, and FINRA

In October, Digital World Acquisition Corporation agreed to take former US President Donald Trump's new social media company public. On the day of the announcement, Digital World's stock price surged 357% with a volume of more than 471 million shares (Walsh). Digital World's plans to merge with Trump's venture date back to April when Patrick Orlando, CEO of the blank-check, first began discussions with Trump's representatives. However, the order in which the deal was conductedwas unorthodox and potentially unethical. Blank-check SPACs are first supposed to sell their shares to investors before making a deal to merge with a business. After seeing reports that Orlando and Trump's team had taken prior meetings, the SEC and the Financial Industry Regulatory Authority (FINRA) to inquire for details and seek out an investigation on the matter. The SEC is particularly interested in documents that contain any communication between Digital World and Trump's Venture, including "meetings of DWAC's Board of Directors, policies and procedures relating to trading, the identification of banking, telephone, and email addresses, identities of certain investors, and certain documents and communications between DWAC and Trump Media and Technology Group (TMTG)" (Lyons). FINRA, on the other hand, is looking into a trading review before the merge announcement, which happened on October 20th, 2021. Both investigations are crucial to determining the future of TMTG's Social Media platform and have significant stakes for Digital World too. SPAC shareholders can withdraw their investment at any time before the merger happens, so if Digital World is unable to take the company public, it will be unlikely to keep its investors for long too. In addition to the money that Digital World investors raised, TMTG put out a news release saying that it had come to terms with undisclosed investors to raise over $1 billion in a concurrent private funding round. Digital World has been cooperating with all information and filing requests from the SEC and FINRA and has stated that "the investigation does not mean that the SEC has concluded that anyone violated the law or that the SEC has a negative opinion of Digital World" (Lyons). As of December 12, Digital World's stock is trading at $56 and has a market cap of almost $2 billion. Investigations are still ongoing, and the future of Digital World and TMTG's relationship remains unknown.

Considering the Past and Foreseeing the Future

Remembering Reverse Mergers

The years 2010-2012 had a booming SPAC market of its own with reverse mergers. In a reverse merger, a private company would buy a shell company that had no business model, operations, or assets but was public and would merge with the shell company surviving as the publicly traded entity. In 2011, the SEC investigated foreign US-listed operations and found evidence of dormant shells being abused through Chinese companies entering the US stock market. After the investigation, nearly 400 shells were suspended to prevent fraudulent investing and hijacking of the public markets. Unfortunately, several Chinese companies used the shell companies to pump and dump their stock, making them millions of dollars (Gustav). The SEC then put up a bulletin to caution investors from injecting money into reverse mergers, leading them to extinction. Reverser mergers and SPACs are not regulated identically. SPACs allow investors to withdraw their investments before the merger occurs, allowing shareholders to vote on the proposed merger, and the sponsors retain ownership of the entity. But there are also many shocking similarities. Today's SPACs show similar dynamics to what happened in the early 2010s: "frenzied growth, negative media, and regulatory concern regarding the quality of the targets" (Namovska). With $96 billion invested into SPACs in the first quarter of 2021 alone, there is cause for concern regarding the history of reverse mergers and the future of SPACs.

SEC Involvement

The current chair of the SEC, Gary Gensler, has been vocal about his concerns over the lack of regulation that come with SPACs. Gensler is planning on putting out new requirements for SPACs that could change the landscape for future SPAC mergers because of transactions like Nikola and Clover Health, where financials were hyper-exaggerated. The SEC will require SPACs to provide complete disclosure about their deals and force SPACs to restate their financial results if they do not follow the accounting standards they are supposed to offer to investors (Warren). Gensler is also pushing for more accountability in due diligence from SPAC sponsors, financial advisors, and accountants, similar to underwriters for IPOs (Sorkin). With the SEC moving towards hammering down regulations on SPAC diligence and financials, this could create more even competition between IPOs and SPACs.

Conclusion

The IPO process is long, difficult, and expensive, which makes sense why other routes are so explored. SPACs have generated hundreds of billions of dollars in the public markets over two years. This level of value will not be overlooked and will not be left unsupervised. With recent steps taken by SEC Chairman Gensler, a solution can be found to have proper requirements for SPAC companies that allow them to continue providing an opportunity for private firms to go public.

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