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CASENOTES

CORPORATIONS — SECURITIES LAW — DEFINITION OF SECURITY — FEDERAL SECURITIES LAWS APPLICABLE TO SALE OF A BUSINESS EFFECTUATED BY A STOCK SALE OF ALL THE BUSINESS'S STOCK. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297 (1985).

A father and his sons, managers and sole shareholders of a lumber company,¹ sold the company to a tax attorney and a businessman.² The sale was effected through a transfer of 100 percent of the lumber company's common stock.³ The business did not live up to the purchasers' expectations and eventually went into receivership. The purchasers filed suit in the United States District Court for the Western District of Washington alleging that the sellers violated the federal securities laws by misstating or omitting material facts relating to the prospects of the enterprise.⁴ The district court dismissed the complaint for lack of subject

1. *Landreth Timber Co.*, a Delaware corporation, was purchased by Samuel Dennis, a senior partner and tax attorney with a Boston law firm, and John Bolton, a former client of Mr. Dennis and an experienced businessman. See *Landreth Timber Co. v. Landreth*, No. 80-2-11740-8, slip. op. (W.D. Wash. Apr. 29, 1981), *aff'd*, 731 F.2d 1348 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985), *reprinted in* Appendix Accompanying Petition for Writ of Certiorari, *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297 (1985).
2. The sellers, Ivan K. Landreth and his sons, owned all the outstanding stock of a lumber business they operated in Tonasket, Washington. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2300 (1985).
3. *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1350 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985). A business also may be transferred through the sale of a corporation's assets. This method, not coincidentally, escapes coverage of the federal securities laws. A sale of a business's assets is advantageous to the purchaser because he can pick and choose the assets and liabilities he desires. A sale of stock, however, results in the purchaser succeeding to all the assets and liabilities of a corporation, known or unknown. A closely held corporation may keep a paucity of accurate records and books; therefore, the purchaser of a corporation who purchases by a sale of stock may not know precisely what he has acquired. A stock purchaser must balance the greater risk of a stock transfer against the ease of the stock's transferability, whereas the asset purchaser may have to perfect his title in the many and potentially eclectic interests of the business in question. See A. CHOKA, *BUYING, SELLING AND MERGING BUSINESSES* 2 (3d ed. 1969); J. MCGAFFREY, *BUYING, SELLING AND MERGING BUSINESSES* 1-6 (4th ed. 1979); W. PAINTER, *CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATION* § 8.4 (2d ed. 1981). The form of the transaction also may be dictated by the existence of nonassignable contracts or leases. Faced with this hurdle, the sale will be effected through a stock transfer. For a painful example of the consequences of a nonassignable lease leading to a stock transaction, see *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982) (lease decisive in the transfer of a ticket brokerage business by way of stock rather than assets). For a discussion of the tax treatment of asset and stock purchases, see J. MCGAFFREY, *BUYING, SELLING AND MERGING BUSINESSES* 139-52 (4th ed. 1979); W. PAINTER, *CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATION* § 8.5 (2d ed. 1981). See generally Perry, *Sale of Assets Transactions: What are the SEC's Disclosure Requirements?*, 7 SEC. REG. L.J. 347 (1980) (discussing a "going private" transaction and potential antifraud liability).
4. *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1350 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985).

matter jurisdiction, holding that the sale of the business by transfer of all the stock did not constitute a federal securities transaction; therefore, the federal securities laws did not apply.⁵ The district court analyzed the economic realities of the transaction and ruled the stock was not a security within the meaning of the federal securities laws because the buyers did not enter into the transaction with the anticipation of earning profits derived from the efforts of others.⁶ The district court concluded, therefore, that the sale was not an investment transaction, but a commercial or entrepreneurial transaction.⁷ The United States Court of Appeals for the Ninth Circuit affirmed the district court decision.⁸ The Supreme Court reversed, holding that when a business is sold by the transfer of its stock, the transaction is within the coverage of the Securities Act of 1933⁹ and the Securities Exchange Act of 1934¹⁰ (the Acts) because the stock transferred constitutes a "security" as defined in the Acts.¹¹

Comprehensive federal regulation of securities began with the enactment of the 1933 and 1934 Acts. In the wake of the 1929 stock market crash, with investor confidence at an all-time low, Congress prescribed the Acts as a means to eradicate the abuses of unregulated securities markets, to protect the unwary investor from fraud, and to bolster the investor environment.¹² The Acts have produced a statutory coalition

5. See *Landreth Timber Co. v. Landreth* No. 80-2-11740-8, slip op. (W.D. Wash. Apr. 29, 1981), *aff'd*, 731 F.2d 1348 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985), reprinted in Appendix Accompanying Petition for Writ of Certiorari, *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297 (1985).

6. *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1351 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985). For a discussion of the federal securities laws involved, see *infra* notes 12-20 and accompanying text.

7. *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1351 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985).

8. *Id.* at 1353.

9. 15 U.S.C. §§ 77a-77AA (1982) [hereinafter cited as 1933 Act].

10. 15 U.S.C. §§ 78a-78kk (1982) [hereinafter cited as 1934 Act].

11. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2303 (1985). For the definition of security, see *infra* text accompanying note 18.

12. See S. REP. NO. 47, 73d Cong., 1st Sess. 1-2 (1933), reprinted in 2 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 17 (1973) [hereinafter cited as ELLENBERGER & MAHAR] ([T]he report states that "[t]he aim [of this report] is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misleading representation. . . . Confidence must and may be restored upon the enduring basis of honesty with the public."); PRESIDENT'S RECOMMENDATION TO CONGRESS FOR FEDERAL SUSPENSION OF TRAFFIC IN INVESTMENT, SECURITIES IN INTERSTATE COMMERCE, H.R. DOC. NO. 12, 73d Cong., 1st Sess. 1 (1933), reprinted in 2 ELLENBERGER & MAHAR item 15 ([W]herein President Franklin D. Roosevelt stated: "This proposal . . . puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence."); see also *Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982) (1934 Act was "adopted to restore investors' confidence"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (1933 Act was "designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards

providing for the registration and regulation of securities. Absent an exemption, the offer or sale of a security as defined by the Acts is subject to registration¹³ with the Securities and Exchange Commission.¹⁴ In addition the Acts contain antifraud provisions,¹⁵ including rule 10b-5, which

of honesty and fair dealing"); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) ("[T]he primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market."); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (purpose of 1934 Act is "to protect investors through the requirement of full disclosure by issuers of securities"); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (Acts were to achieve high ethical standards in securities industry). See generally James, *The Securities Act of 1933*, 32 MICH. L. REV. 624 (1934) (discussing the background of the Securities Act and its key provisions); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959) (a glance backward at the legislative history of the Securities Act by one of its key draftsmen); Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959) (discussing statutory framework of regulating the securities markets).

13. The 1933 Act requires the filing of a registration statement with the Securities and Exchange Commission prior to the offer and sale of any security unless the security or the transaction falls into one of the statutory exemptions. See Securities Act of 1933, § 5, 15 U.S.C. § 77(d) (1982). This registration process may be enforced by three different remedies: private civil liability, *id.* § 77k-L; public civil equitable remedies, *id.* § 77t(b); and public criminal action, *id.* §§ 77t(b), 77x. The 1934 Act addresses the trading markets and provides that securities traded on a national exchange or held by more than 500 persons must be registered. See 15 U.S.C. §§ 78L(b), 78(g) (1982).
14. See Securities Act of 1933, 15 U.S.C. § 77c(a)(1)-(8) (securities exempt from registration); *id.* §§ 77c(a)(9)-(11), 77c(b), 77d (transactions exempt from registration). The first of the major statutory exemptions is the nonpublic offering exemption of section 4(2). Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1982). This section allows an issuer to sell unlimited quantities of unregistered securities provided the offering is not public. *Id.* Section 77d(2) has been hailed as the most popular exemption of all. Thomforde, *Relief for Small Businesses: Two New Exemptions from SEC Registration*, 48 TENN. L. REV. 323, 325 (1981). The "safe harbor" rule for section 77d(2) is SEC regulation D, rule 506. 17 C.F.R. 230.506 (1985). Section 3(b) contains the second major exemption from registration. Securities Act of 1933, 15 U.S.C. § 77C(b) (1982). Congress empowered the SEC to promulgate limited exemptions to offerings up to five million dollars provided the public interest is served and the investor is protected. The SEC in the spring of 1982 adopted a series of six rules, known as Regulation D to fulfill its implementing powers. 17 C.F.R. §§ 230.501-.506 (1985). Another major exemption is the intrastate offering exemption, embodied in section 77c(a)(11). Securities Act of 1933, 15 U.S.C. § 77c(a)(11). This exemption hinges on the offering being extended to only the resident of a single state. *Id.* In adopting these exemptions, Congress believed that investors, in narrow areas, required no protection of the registration scheme by reason of the small amount involved or the limited character of the public offering. See H.R. REP. NO. 1542, 83d Cong. 2d Sess., reprinted in 1954 U.S. CODE CONG. & AD. NEWS 2973.
15. See 15 U.S.C. §§ 77l(2), 77q (1982). These two sections comprise the antifraud provisions of the 1933 Act. Section 77l(2) provides a cause of action for rescission or damages against the seller using material misrepresentations in the offer or sale of a security "whether or not exempted by the provisions of section (c) and (d)" (the provisions exempting certain transactions or instruments). Section 77q is a general antifraud provision prohibiting fraudulent devices or material misrepresentations or omissions in the offer or sale of any security. The 1934 Act's antifraud rule, the "workhorse" rule 10b-5, enacted pursuant to 15 U.S.C. § 78j(b), states:

It shall be unlawful for any person, directly or indirectly, by the use of any

prohibits material misrepresentations, omissions, and the use of fraudulent devices when the security is offered or sold. Significantly, these antifraud provisions apply with equal force whether the instrument is registered or exempt.¹⁶ As a result, although a security may be exempt from the registration requirements, it remains subject to the antifraud rules.

The Acts, including their plaintiff-oriented antifraud provisions and federal jurisdiction, apply only if the transaction involves the transfer of a "security" as delineated in the Acts.¹⁷ Thus, the threshold inquiry in

means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1985).

16. See *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) ("[W]e read § 10(b) to mean that congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face."). Essential to understanding the ramifications of rule 10b-5 is that although the 1934 Act is concerned primarily with securities transactions issued by publicly held corporations, rule 10b-5 clearly impacts on the closely held issuer as well. See section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (giving the SEC an omnibus grant of authority to promulgate rules prohibiting fraud "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered." (emphasis supplied)).
17. A plaintiff gains tremendous advantages when granted federal jurisdiction. The 1934 Act provides for exclusive federal jurisdiction, broad venue, and nationwide service of process provisions. See 15 U.S.C. § 78aa (1982). In addition, the elements of the federal antifraud provisions are easier to prove than the elements of common law fraud. L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 808-17 (1983) (discussing the Acts' fraud provisions compared to common law deceit); W. PROSSER & W. KEETON, *PROSSER AND KEETON ON THE LAW OF TORTS* §§ 105-108 (5th ed. 1984) (discussing the tort action of deceit). A federal 10b-5 cause of action is less severe; see, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (reliance not a necessity in rule 10b-5 action); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193-95 (1963) (comparing common law fraud to the antifraud provisions of the Acts); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.) (improper motive not necessary, just knowledge or recklessness), *cert. denied*, 439 U.S. 970 (1978); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*) (no scienter needed), *cert. denied*, 404 U.S. 1005 (1971). But see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (strict scienter requirement requiring intent to deceive, manipulate, or defraud for violation of rule 10b-5). Recklessness as scienter is still an open question; the privity element has survived and must still be proven in a federal securities action. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) (which requires the plaintiff to be a buyer or seller of securities); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975) (approving the *Birnbaum* rule); see generally Long, *Don't Forget the Securities Acts!* 26 OKLA. L. REV. 160, 174-91 (1973) (summarizing the advantages of federal, as opposed to common law fraud, as: (1) ease of proof; (2) greater damage recovery; and (3) extended liability).

determining the applicability of federal securities law is the interpretation of the term "security." There is, however, no generic definition of the term "security;" instead, the Acts define security in a laundry list fashion. Section 2(1) of the Securities Act of 1933 defines "security" as follows:

[U]nless the context otherwise requires - (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest on participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹⁸

This definition includes well known instruments such as stocks, bonds and debentures. The definitional section also contains less identifiable instruments such as evidences of indebtedness and investment contracts which are referred to in catch-all terms but are intended to include "the many types of instruments that in our commercial world fall within the ordinary concept of a security."¹⁹ Moreover, because the Acts were intended to be remedial legislation to give investors equal footing with sellers, courts have interpreted the term "security" in an expansive manner capable of adaptation to meet the "countless and variable schemes

18. 15 U.S.C. § 77b(1) (1982). The Securities Exchange Act of 1934 contains a definition that is virtually identical. See 15 U.S.C. § 78c(a)(10) (1982). The legislative history of the 1934 Act notes the definition was to be "substantially the same" as the 1933 Act. S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934). A note with a maturity of nine months or less, however, is a security for purposes of the 1933 Act but not for the 1934 Act. *Reufenacht v. O'Halloran*, 737 F.2d 320, 327 (3rd Cir. 1984); *Exchange Nat. Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1131-32 (2d Cir. 1976). As a result, a transaction involving such an instrument thus may create antifraud liability under the 1933 Act, although there would be no liability for a registration violation under the rule 10b-5 of the 1934 Act. Otherwise, the Supreme Court has regarded the two definitions as being *in pari materia*. See *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2302 n.1 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335-36, 342 (1967).

Despite the definitional sections of the Acts, what constitutes a security has been perceived as "one of the best kept secrets in recent legal history. The Securities Act of 1933 purports to define the term, but the definition itself presents a Pandora's box of imposing dimensions." Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 219 (1974).

19. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847-48 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933)).

devised.”²⁰

The Supreme Court has addressed the definition of a security on ten occasions since the Acts’ inception,²¹ but *SEC v. W. J. Howey Co.*²² remains the definitive decision by the Court on what constitutes a “security.” In *Howey*, the issue was whether the purchase of citrus groves constituted an investment contract - an instrument enumerated in the “security” definition.²³ Florida vacationers were offered a strip of a citrus grove together with a service contract for cultivation and marketing of the fruit.²⁴ Holding that the scheme constituted a “security,” the *Howey* Court isolated the elements of an investment contract as follows: (1) investment of money; (2) in a common enterprise; (3) with profits to come solely from the efforts of others.²⁵ This tripartite investment contract test has come to be known as the “economic realities” test or “*Howey*” test and it is the hallmark in determining whether a transaction involves an investment contract. The *Howey* Court emphasized that to effectuate the remedial federal securities laws, a workable formula was necessary: form should be disregarded for substance, and emphasis should be placed upon “economic reality.”²⁶

Twenty-nine years later, in *United States Housing Foundation, Inc. v. Forman*,²⁷ the Court addressed the amorphous definition of a security in the context of stock. The plaintiffs in *Forman* resided in a nonprofit housing cooperative. To acquire their apartments, the tenants were required to buy stock.²⁸ The residents sued the leasing company alleging violations of the Acts’ antifraud provisions.²⁹ The Second Circuit, applying a literal interpretation to the definition of a “security,” had held that

20. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

21. The ten cases are: *Gould v. Rufenacht*, 105 S. Ct. 2308 (1985); *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297 (1985); *Marine Bank v. Weaver*, 455 U.S. 551 (1982); *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

22. 328 U.S. 293 (1946).

23. *Id.* at 294.

24. *Id.* at 294-96. The SEC sought to enjoin the defendants from offering and selling unregistered securities in violation of section 5 of the 1933 Securities Act. *Id.* at 294.

25. *Id.* at 298-99.

26. *Id.* at 298.

27. 421 U.S. 837 (1975).

28. *Id.* at 842. Each purchaser had to buy eighteen shares of “stock” for each apartment room in “Co-op City,” a privately owned, state-subsidized, nonprofit housing cooperative in the Bronx, New York City, at a cost of \$25 per share, resulting in a total cost of \$450 per room. *Id.*

29. *Id.* at 844-45. An “Information Bulletin” issued before construction began on “Co-op City” projected that the average monthly rental cost would be \$23.02 per room. The cost of construction, however, increased dramatically due to inflation. The end result placed the average monthly rental fee at \$39.68 per room. *Id.* at 843-44. This unpleasant turn of events prompted a class action suit by the tenants who alleged misrepresentation via the “Information Bulletin.” *Id.* at 844. Ostensibly, the tenants

because the instrument possessed the label "stock," the instrument was a security; therefore, the Acts' antifraud provisions applied.³⁰

On appeal, the Supreme Court held the stock was not a security and, therefore, was not within the ambit of the federal statutes.³¹ The Court eschewed the Second Circuit's literal interpretation of the definition of a "security."³² In so doing, the Court declared that "a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."³³ The Court held that because Congress spurned a literal approach to the Acts' application,³⁴ the applicability of the Acts turns on the "economic realities" underlying a transaction.³⁵ Hence, although the *Forman* instrument was labelled stock, the instrument lacked the requisite characteristics associated with traditional stock.³⁶ The Supreme Court identified the characteristics of stock to include the right to receive dividends contingent upon an appor-

were led to believe that future cost increases would be absorbed by the developers. *Id.*

30. *Forman v. Community Services, Inc.*, 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom.* *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).
31. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 859-60 (1975).
32. *Id.* at 848. The Court of Appeals for the Second Circuit in *Forman* held that the shares of stock were commensurate with "securities" and based its decision on two alternative grounds, which later constrained the Supreme Court to deal with the question in similar fashion. First, the intermediate appellate court held that because the shares purchases were denominated "stock," the literal application of the "security definition" invoked coverage of the federal securities laws. *Forman v. Community Services, Inc.*, 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom.* *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975). Second, the court of appeals labeled the transaction an "investment contract" as delineated by the *Howey* test. *Id.* at 1253-55. The Supreme Court likewise rendered its decision in several parts. Part I set out the detailed but simple fact pattern. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 840-47. Part II was devoted to the definition of a "security" as delineated by the Acts. *Id.* at 847-48. Part IIA contains the Court's rejection of a literal approach to the definition. *Id.* at 848-51. More importantly, as *Landreth* would later stress, the Court found the "stock" to be titular: the instrument manifested none of the essential attributes of inveterate, conventional stock. *Id.* at 848-51. Part IIB contained the Court's discussion of whether the instrument could march through the *Howey* "investment contract" test. *Id.* at 851-58. The *Forman* decision has not enjoyed a uniform interpretation. *See infra* note 45 for the consequences of *Forman's* bifurcated analysis.
33. *Id.* at 849 (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)); *see also United States v. American Trucking Ass'ns*, 310 U.S. 534, 543 (1940) ("[E]ven when the plain meaning [of a statute] did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole' this Court has followed that purpose, rather than the literal words." (citations omitted)).
34. *Id.* at 849. Congress sought to define the term "security" in the 1933 Act "to include . . . the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933).
35. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848, 851-52 (1975). This principle was utilized earlier in *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967), and *SEC v. W.J. Howey*, 328 U.S. 293, 298 (1946).
36. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975). Although the instrument in *Forman* was called stock, it prohibited transferability, conferred no vot-

tionment of profits, negotiability, the ability to be pledged or hypothecated, the conference of voting rights in proportion to the number of shares owned and the capacity of the stock to appreciate in value.³⁷ Having concluded the instrument in question was not typical "stock," the *Forman* Court then addressed whether the instrument was an investment contract. The Court resorted to the *Howey* test, which "embodies the essential attributes that run through all of the Court's decisions defining a security."³⁸ The Court then proceeded to apply the *Howey* test³⁹ to the *Forman* instrument, because in this transaction the Court could perceive no distinction between the stock and an investment contract.⁴⁰ The Court found that the transaction was entered into without an expectation of profits from the efforts of others, thus it did not satisfy the *Howey* test. Consequently, the Court ruled that when a purchaser is motivated by a desire to use, consume, or develop that which he acquires, the purchase is not an investment, but a commercial transaction which fails to activate the protections of the Acts' antifraud provisions.⁴¹

Forman's application of the *Howey* economic realities test to stock formed the fundamental precept to the sale of business doctrine. The sale of business doctrine would deny the protection of the federal securities laws to parties buying and selling common stock to obtain control of a corporation. The rationale of the doctrine is that when a business changes hands through the sale of a controlling block of its stock, that stock is not a security within the contemplation of the Acts.⁴² Courts

ing rights, and provided no opportunity for dividends or profit upon resale. *Id.* at 851.

37. *Id.* at 851.

38. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). That test is the "economic realities" test promulgated in *SEC v. W.J. Howey*, 328 U.S. 293, 301 (1946).

39. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975). The Court stated: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Id.* at 852.

The *Forman* Court revised the *Howey* test in two ways. The first part of the *Howey* test calls for an "investment of money." *Howey*, 328 U.S. at 301. *Forman* reconstructed this prong to include simply an "investment." *Forman*, 421 U.S. at 852. The third part of the *Howey* test required an inquiry into whether the transaction involved "profits solely from the efforts of others." *Howey*, 327 U.S. at 301 (emphasis added). *Forman*, however, altered the phrase by jettisoning the word "solely." *Forman*, 421 U.S. at 852. The efficacy of this alteration allows a purchaser to contribute some effort to generate profits without losing the label investor, as long as the purchaser's efforts were not too significant. It is clear that even the reconstructed *Howey* test requires the plaintiff to show the promoter's or a third party's efforts, instead of his own, were the linchpin to the success of the venture. *Forman*, 421 U.S. at 852.

40. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975). The stock lacked all traditional characteristics except the name "stock." *Id.* at 851.

41. *Id.* at 858.

42. *See, e.g., Christy v. Cambron*, 710 F.2d 669 (10th Cir. 1983) (sale of a controlling interest in a discotheque effected through transfer of stock was not a securities transaction); *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982) (sale of radio station not

embracing this view spurned a literal interpretation of the definition of security and, in effect, created an exclusion from the coverage of the federal securities laws. The doctrine was applied for the first time in *Chandler v. Kew, Inc.*,⁴³ decided twenty months after *Forman*. In *Chandler*, the aggrieved buyer acquired a liquor store by purchasing 100 percent of the stock from its owners. The Tenth Circuit focused on the substance of the transaction, which was the sale of the liquor store, and concluded that the economic realities barred the application of federal securities laws because the stock was merely an indicia of ownership.⁴⁴ The *Chandler* decision, as progenitor, prompted other federal courts to hold that in the conventional sale of a business, which involves the transfer of both a business and all of its stock, fundamentally the buyer acquires a business and only acquires the stock as indicia of ownership.⁴⁵

Courts that initially adopted the "sale of business doctrine" interpreted the *Forman* case to mean that the sole criterion of whether stock is a security is the transaction's satisfaction of the *Howey* economic realities test.⁴⁶ These courts held that *Forman* extended the *Howey* test to include all instruments within the definition of security,⁴⁷ thereby al-

within the coverage of federal securities laws); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982) (sale of heating and air conditioning business not a securities transaction).

43. 691 F.2d 443 (10th Cir. 1977).

44. *Id.* at 444.

45. *Chandler* was important because it implicated *Howey* and *Forman*, both of which served as the basis for the substantial, but now short-lived *Chandler* progeny. See *infra* notes 63-66 and accompanying text.

46. See, e.g., *Christy v. Cambron*, 710 F.2d 669, 672 (10th Cir. 1983) ("[T]he economic realities of the case at bar show that plaintiffs were buying a discotheque, and there is no question about that."); *King v. Winkler*, 673 F.2d 342, 345 (11th Cir. 1982) ("[b]ased on the rationale of *Forman*, we reject a literal test and hold that the 'economic realities' test is appropriate to determine whether a transaction involving stock in a corporation is a 'security transaction' or an 'investment contract' governed by the Federal Securities Acts."); *Frederiksen v. Poloway*, 637 F.2d 1147, 1151 (7th Cir.) ("[t]he *Forman* Court applied an 'economic reality' analysis [to determine] the scope of federal securities laws."), *cert. denied*, 451 U.S. 1017 (1981).

47. See, e.g., *Christy v. Cambron*, 710 F.2d 669, 672 (10th Cir. 1983) ("[t]he attribute of a security is that it represents an investment in a venture which derives profits from the entrepreneurial or managerial efforts of others." (emphasis in original)); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465 (7th Cir. 1981) ("economic reality" is always the key issue in determining whether stock is a security). Cases rejecting the doctrine interpret *Forman* entirely differently. According to these courts, *Forman* applied a two-part seriatim test; they reason that the *Forman* Court turned to the *Howey* investment contract test only after assessing that the transaction involved aberrant stock. Consequently, if conventional stock is transferred, then the *Howey* test is preempted. See, e.g., *Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin v. Polishing Machine, Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *infra* notes 67-71 and accompanying text.

Courts faced with the issue to accept or reject the sale of business doctrine invariably turn to *Forman* for guidance. The ubiquitous *Forman* opinion can be found in every federal opinion deciding the issue. See Easley, *Recent Developments in the Sale of Business Doctrine: Toward a Transactional Context Based Analysis for*

lowing the *Howey* test to engulf the definition of security. Aggrieved buyers of businesses thus invariably failed the *Howey* economic realities test because profits would not flow from the efforts of others but instead would be derived from the buyer's own efforts.⁴⁸ Moreover, these courts drew a line of demarcation between a commercial or entrepreneurial transaction and one made for investment purposes.⁴⁹ Buyers who profited from their own efforts were not investors but entrepreneurs.⁵⁰ Courts

Federal Securities Jurisdiction, 39 BUS. LAW 929, 933 (1984). One commentator has stated that the role of *Forman* in the sale of business milieu has been reduced to ammunition in a "quotation contest." Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982). Language in *Forman* supports both sides of the "sale of business doctrine" dispute. For instance, the Court stated "[i]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *United States Hous. Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975) (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)). Sale of business doctrine advocates find solace in the Court's discussion of the Acts' purpose where it is stated, "[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." *Id.* at 849. In discussing the difference between an "investment contract" and an instrument commonly known as a "security," the Court stated that, "[i]n either case, the basic test for distinguishing the transaction from other commercial dealings is the *Howey* test." *Id.* at 852. The Court then stated: "This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security." *Id.* Conversely, those rejecting the doctrine can also turn to *Forman* wherein the Court states:

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Id. at 850-51.

48. See, e.g., *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1353 (9th Cir. 1984), (court unable to find a third-party upon whose efforts the purchaser relied for its profit within the meaning of *Howey*) *rev'd on other grounds*, 105 S. Ct. 2297; *King v. Winkler*, 673 F.2d 342, 344 (11th Cir. 1982) (requirement that profits be derived from efforts of others not satisfied as aggrieved buyer took over management of the business); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 463-64 (7th Cir. 1981) (buyer, upon purchase, took over management of the company making the buyer and the company indistinguishable).
49. E.g., *Sutter v. Groen*, 687 F.2d 197, 203 (7th Cir. 1982) (establishing a presumption of entrepreneurial intent when buyer acquires more than 50% of a corporation's stock making Acts inapplicable); *King v. Winkler*, 673 F.2d 342, 344-45 (11th Cir. 1982) (profit emanating from entrepreneurial efforts of buyer renders Acts inapplicable); *Fredericksen v. Poloway*, 637 F.2d 1147, 1148, 1152-53 (7th Cir.) (Act does not apply where purchaser places money in hands of another who will control the funds and the business decisions), *cert. denied*, 451 U.S. 1017 (1981); see also, *Thompson, The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U.L. REV. 225, 240 (1982) (arguing that although a purchaser of all of the stock of a business is making an investment, it is not the type of transaction intended to be covered by the Acts).
50. See *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1352 (doctrine's foundation

accepting the doctrine reasoned that Congress designed the federal securities laws to protect investors unable to fend for themselves, rather than purchasers who subsequently manage the enterprise.⁵¹ This contention is buttressed by a reading of the legislative history behind the Acts which is silent as to those sophisticated buyers who obtain control of a corporation by purchase of the corporation's stock.⁵²

In *Marine Bank v. Weaver*,⁵³ the Court injected an additional rationale in support of the sale of business doctrine. At issue in *Marine Bank* was whether a bank certificate of deposit and a profit-sharing agreement were securities.⁵⁴ Regarding the certificate of deposit, the Court acknowledged that the instrument was among those enumerated in the definition of securities provided in the Acts,⁵⁵ but relied upon the qualifying language prefacing the definition — "unless the context otherwise requires" — to exclude the instrument from the definition of a security.⁵⁶ The Court examined the context under which the certificate of deposit was issued and determined that the holders of this instrument did not require the protection of the federal securities laws.⁵⁷ Thus, the *Marine Bank* Court, similar to courts adopting the sale of business doctrine, rejected a strict literalist interpretation of "security" and relied on the caveat in the Act's definition to exclude the instrument.⁵⁸

The *Marine Bank* case, finding that the prefatory language required a holding that an instrument enumerated in the statute may not necessarily be a "security," seemed to settle the judicial dialogue concerning the significance of the phrase, "unless the context otherwise requires."

based on predicate that Acts apply to investment transactions, not entrepreneurial transactions), *rev'd on other grounds*, 105 S. Ct. 2297 (1985); *Sutter v. Groen*, 687 F.2d 197, 201 (7th Cir. 1982) (same).

51. See *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *infra* note 108.

52. See *Sutter v. Groen*, 678 F.2d 197 (7th Cir. 1982).

53. 455 U.S. 551 (1982).

54. *Id.* at 552. The plaintiffs purchased this instrument from the bank. Subsequently, they pledged it back to the bank as collateral for another customer's loan made by the bank to a slaughterhouse company. *Id.* at 552-53. As consideration for the guarantee on the loan the plaintiffs entered into a profit-sharing agreement with the owners of the slaughterhouse giving the plaintiffs the right to receive 50% of the net profits of the meat packer and \$100.00 per month for the life of the guarantee. Also, the plaintiffs were granted the right to use the company's barn and pasture in addition to the right to limit the company's future borrowing. *Id.* at 553.

55. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

56. See *id.* at 556, 558-59. The import of the *Marine Bank* decision, like every other aspect of the sale of business doctrine, has been hotly debated. It has been interpreted as rejuvenating the spirits of doctrinal proponents. See Ribskin, *Securities Regulation*, 34 MERCER L. REV. 1461, 1484 (1983); Note, *Function Over Form: The Sale of Business Doctrine and the Definition of "Security,"* 63 B.U.L. REV. 1129, 1146 (1983). But see Kerjala, *Realigning Federal and State Roles in Securities Regulation Through The Definition of a Security*, 1982 U. ILL. L. REV. 413, 430-35.

57. 455 U.S. at 558-59. In finding the context otherwise required, *Marine Bank* emphasized that the plaintiff was not entitled to federal securities coverage because certificates of deposit are sufficiently protected by a comprehensive scheme of regulation under the federal banking laws. *Id.* at 559.

58. *Id.* at 556, 558-59.

Marine Bank interpreted the phrase to require an inquiry into the context of the circumstances surrounding the instrument, not the context of the statute.⁵⁹ This reading of the phrase enabled the Court to exclude the certificate of deposit from the securities laws by examining the transaction's economic realities. Thus, proponents of the sale of business doctrine began to rely on *Marine Bank's* interpretation of the phrase to signal that courts should examine the economic context of every transaction, even though the instrument may be expressly enumerated in the "security" definition. This construction of *Marine Bank* furthered the view that, although stock is enumerated in the statutory security definition, it may not be a security if the context of the transaction indicates otherwise.⁶⁰

Additionally, the *Marine Bank* Court ruled that the profit-sharing agreement, also explicitly within the statutory definition of security, was not a security because the agreement did not satisfy the *Howey* test.⁶¹ The Court discussed the "common enterprise" element of the *Howey* test and found that instruments accorded security status in earlier Supreme Court cases were harmonious in that each had been offered to a large number of investors.⁶² Because the agreement was really a private transaction it was

59. Prior to *Marine Bank*, a dispute centered on whether the word "context" referred to the underlying context of the transaction or the context of other sections of the Securities Acts. A restrictive view of the phrase read "context" to mean the statutory context. Thus, under this view, the definitions in the statutory language were to govern unless the language surrounding the term elsewhere in the Act indicated otherwise. See *SEC v. National Securities, Inc.*, 393 U.S. 453, 459 (1969) (Congress . . . cautioned that the same words may take on a different coloration in different sections of the securities laws). By contrast, another view of the caveat has been construed as a vehicle to examine the underlying circumstances of the transaction in order to determine the applicability of the Acts. See *Sutter v. Groen*, 687 F.2d 197, 200 (7th Cir. 1982) (Referring to *Marine Bank*, the Seventh Circuit stated: "The Court got around the seemingly uncompromising statutory language by treating the word 'context' in the introductory clause of section 3(a)(10) as having reference to the economic as well as linguistic context."). In *Marine Bank*, the Court took the certificate of deposit out of the "security" context because of the economic circumstances of the transaction: the purchasers were fully protected by the plethora of federal banking laws. See *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982). Courts adopting the sale of business doctrine therefore used the caveat to the definition to take stock, which is specifically enumerated in the statute, out of the statute. See *Sutter v. Groen*, 687 F.2d 197, 200 (7th Cir. 1982) (interpreting *Marine Bank's* "context" discussion as referring to the economic context of the transaction); *Frederiksen v. Poloway*, 637 F.2d 1147, 1150 (7th Cir.) (relying on "context" aspect of definition to restrict scope of Acts), *cert. denied*, 451 U.S. 1017 (1981).

60. See *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); see also Easley, *Recent Developments in the Sale of Business Doctrine: Toward a Transactional Context Based Analysis for Federal Securities Jurisdiction*, 39 BUS. LAW 929 (1984) (arguing that *Marine Bank's* "context" discussion mandates that all factors and risks of the transaction be examined to define Acts' scope).

61. *Marine Bank v. Weaver*, 455 U.S. 551, 559-60 (1982).

62. *Id.* at 559. The control element of the *Howey* test, the "efforts of others," was also discussed in *Marine Bank* in relation to the profit sharing agreement. The "efforts of others" element was not satisfied because the plaintiff retained the right to veto future loans and, thus, maintained a measure of control. *Id.* The *Marine Bank*

"not the type of instrument that comes to mind when the term 'security' is used."⁶³ The Court therefore lent credence to the notion that the *Howey* test is applicable not only when examining the characteristics of uncommon instruments, but also when examining the characteristics of common instruments enumerated within the statutory definition of security. Moreover, the Court admonished that courts must analyze and evaluate each transaction upon the content of the instrument, the purposes of the Acts, and the peculiar facts of each case.⁶⁴ The Court buttressed its conclusions by stating that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."⁶⁵ Of even greater import to sale of business proponents was the Court's refusal to label the agreement a security because it was the fruit of a private transaction.⁶⁶ Significantly, the sale of a closely held business is usually the result of arms-length negotiations between the parties, also a private transaction.

Within the eight years prior to *Landreth Timber Co. v. Landreth*,⁶⁷ the federal circuits were divided on the viability of the sale of business doctrine. The United States Court of Appeals for the Seventh,⁶⁸ Ninth,⁶⁹ Tenth,⁷⁰ and Eleventh⁷¹ Circuits followed the doctrine. Conversely, the Second,⁷² Third,⁷³ Fourth,⁷⁴ Fifth,⁷⁵ and Eighth⁷⁶ Circuits rejected the

profit-sharing agreement, termed a "unique agreement," was not traded publicly but was negotiated privately. *Id.* As a result, the plaintiffs were given no prospectus and the agreement was not designed for public trading and was "not the type of instrument that comes to mind when the term 'security' is used and does not fall within the 'ordinary concept of a security.'" *Id.* at 559.

63. *Id.*

64. *Id.* at 560 n.11. The Court stated:

It does not follow that a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a "security" as defined by the federal statutes. *Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.*

Id. (emphasis supplied).

65. *Id.* at 556.

66. *Id.* at 559-60.

67. 105 S. Ct. 2297 (1985).

68. See *Sutter v. Groen*, 687 F.2d 197, 199-204 (7th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147, 1151-52 (7th Cir. 1981).

69. See *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1353 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985).

70. See *Christy v. Cambron*, 710 F.2d 669, 672 (10th Cir. 1983).

71. See *Kaye v. Pawnee Const. Co.*, 680 F.2d 1360, 1366 n.2 (11th Cir. 1982); *King v. Winkler*, 673 F.2d 342, 344-46 (11th Cir. 1982).

72. See *Golden v. Garafalo*, 678 F.2d 1139, 1140-47 (2d Cir. 1982).

73. See *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3rd Cir. 1984); *Glick v. Campagna*, 613 F.2d 31, 35 (3rd Cir. 1979).

74. See *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1261 (4th Cir. 1974).

75. *Daily v. Morgan*, 701 F.2d 496, 497-504 (5th Cir. 1983).

76. See *Cole v. PPG Indus., Inc.*, 680 F.2d 549, 555-56 (8th Cir. 1982). For cases re-

sale of business doctrine, treating stock as a security for purposes of the Acts without questioning the transactions' economic realities.

Whether the sale of stock of a closely held corporation was a securities transaction subject to the antifraud provisions of the federal securities laws was presented to the Supreme Court in *Landreth Timber Co. v. Landreth*.⁷⁷ The Court held that if an instrument bears the label "stock" and possesses the requisite characteristics associated with stock,⁷⁸ a court may not go beyond the character of the instrument and analyze the economic substance of the transaction.⁷⁹

The Court noted that, by the very language of the statute, stock is within the definition of a security enumerated in the Acts.⁸⁰ Consequently, most instruments affixed with the title "stock" are likely to be covered by the definition. The Court acknowledged that coverage by the Acts is not invoked merely because the instrument bears the label "stock," but that a further determination also must be made as to whether the instrument possesses the five elements traditionally associated with stock.⁸¹ The Court concluded that if an instrument is called stock, and possesses the characteristics associated with stock, then a purchaser of a business may assume that the instrument is a security to which federal securities laws apply.⁸² It was undisputed that the stock transferred in *Landreth* possessed all the characteristics traditionally associated with stock.⁸³ The Court therefore concluded that "the stock at issue here is a 'security' within the definition of the Acts, and the sale of business doctrine does not apply."⁸⁴

The Court distinguished *United Housing Foundation, Inc. v. Forman*⁸⁵ by observing that the stock in *Forman* possessed none of the typical characteristics of conventional stock.⁸⁶ Thus, in *Forman* the Court went on to consider whether the instruments were "investment contracts" pursuant to the *Howey* test.⁸⁷ The Court's application of the *Howey* test in *Forman* led to the conclusion that the economic substance of the transaction, to secure inexpensive housing, was not the type of

jecting the doctrine at the district court level, see *Sterling Recreation Org. Co. v. Segal*, 537 F. Supp. 1024, 1026-27 (D. Colo. 1982); *Mifflin Energy Sources, Inc. v. Brooks*, 501 F. Supp. 334, 336 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445, 449 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925, 930 (E.D. Pa. 1976).

77. 105 S. Ct. 2297 (1985).

78. For a list of these characteristics, see *supra* note 36.

79. 105 S. Ct. at 2302-03.

80. *Id.* at 2302.

81. *Id.*

82. *Id.* at 2303.

83. *Id.* at 2302-03.

84. *Id.* at 2308.

85. 421 U.S. 837 (1975).

86. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2302-04 (1985); see *supra* notes 32-33 and accompanying text.

87. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2304 (1985).

investment contemplated by the Acts.⁸⁸

The Court acknowledged that its previous attempts to define "security" had "not been entirely clear."⁸⁹ This was, however, because its prior inquiries into the underlying economic substance of the transactions were necessitated by the unusual characteristics of the "securities" involved.⁹⁰ But the Court noted that the *Howey* test remains a viable method to determine if stock is a security, provided the instrument fails to possess the traditional characteristics of stock.⁹¹ The *Howey* test is inappropriate, however, if used to determine whether a particular instrument, other than an investment contract, "fits within any of the examples listed in the statutory definition of 'security.'"⁹² The Court reasoned that application of the *Howey* test in all circumstances would render superfluous the specific enumerations within the statutory definition of a security.⁹³

In addition, the Court marshalled strong policy reasons for not applying the sale of business doctrine to sellers of businesses who effect the sale through a stock transfer. According to the Court, application of the sale of business doctrine to *Landreth*, and to cases in which less than 100 percent of the stock was sold, would require a determination of whether control has passed to the purchaser. If control passes to the purchaser, then according to sale of business doctrine advocates, the stock transferred would not be a "security" under the *Howey* test.⁹⁴ Control is diffi-

88. *Id.*

89. *Id.* at 2303-05; see, e.g., *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (bank certificate of deposit and a privately negotiated profit sharing agreement not a "security"); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975) (titular stock not a "security"); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (withdrawable capital shares in a state savings and loan association termed a "security"); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (orange groves deemed "securities"); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (oil leases deemed "securities").

90. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2304 (1985).

91. *Id.* at 2305 n.5.

92. *Id.* at 2305.

93. *Id.* (citing *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982) and *Tcherepnin v. Knight*, 389 U.S. 332 (1967)). The *Golden* decision is particularly instructive because the issue was whether corporate stock constituted a "security." The court stated: "If the 'economic reality' test were to be the core of the definition, only general catch-all terms would have been used." *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982); see also *Prentice & Roszkowski, The Sale of Business Doctrine: New Relief From Securities Regulation or a New Haven for Welshers?*, 44 O.S.U. L.J. 473, 498-99 (1983) (arguing that *Howey* test should be applied only to an investment contract).

94. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2307 (1985). The Court focused on the district courts' onerous burden of engaging in meticulous factfinding regarding the passage of control and requesting supplemental facts on the control question before deciding the case. *Id.* In *Gould v. Ruefenacht*, 105 S. Ct. 2308 (1985), the companion case to *Landreth*, the Court manifested a deeper concern for the control issue when less than 100 % of a company's stock is sold. In *Gould*, a case involving the transfer of 50 % of a company's stock, the Court noted that control hinges on variables such as voting rights, veto rights, or requirements for a super-majority vote on corporate management issues. *Id.* at 2310-11. The key control factor works to create even more nebulous inquiries because control can be gained by acquiring less than 50 % of a company's stock. *Id.* at 2311. The fact finding chore would

cult to determine and frequently can not be determined until the completion of extensive factfinding.⁹⁵ The resulting uncertainty as to the Acts' applicability would be antithetical to the best interest of both the buyer and seller.⁹⁶ To avoid this uncertainty, the Court held that stock is not taken out of the ambit of the statutory definition of security merely because control passes to the purchaser.⁹⁷

With respect to stock, the *Landreth* decision represents a clear resuscitation of the interpretation of the federal securities laws that existed prior to *Chandler v. Kew, Inc.*⁹⁸ Before *Chandler*, cases considering the sale of stock in a corporation routinely denominated the stock as a security for purposes of the Acts without examining a transaction's economic realities.⁹⁹ The *Chandler* era, however, spawned a willingness by courts to depart from a strict statutory framework to exclude transactions that involve the sale of a business from coverage under the Acts. The *Landreth* opinion, marks the demise of those courts' mischaracterization of "stock" to avoid the scope of the Acts.¹⁰⁰

It is worth noting that *Landreth* expressly left untouched the question of whether "notes," "bonds," or "some other category of instrument listed in the definition" are subject to federal securities laws in all circumstances.¹⁰¹ In *Landreth*, the Court espoused significant policy considerations for finding that the stock transferred should come within the ambit of the federal securities laws.¹⁰² The Court acknowledged that there could be countervailing policy considerations for refraining from a strict

become increasingly burdensome because resolution of the control issue requires extensive inquiries into the innerworkings of each corporation to decipher whether the purchase at issue gave the purchaser control. *Id.* at 2311. With the *Gould* opinion, the Supreme Court made it clear that the "sale of business doctrine" does not apply to stock regardless of the quantity of stock transferred.

95. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2307 (1985).

96. *Id.*

97. *Id.*

98. See *supra* notes 41-42 and accompanying text.

99. See *Spencer Co. v. Armark Indus., Inc.* 489 F.2d 704 (1st Cir. 1973); *Walling v. Beverly Enter.*, 476 F.2d 393 (9th Cir. 1973); *Chiodo v. General Waterworks Corp.*, 380 F.2d 860 (10th Cir.), *cert. denied*, 389 U.S. 1004 (1967); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961); *Special Transp. Servs., Inc. v. Baltimore*, 325 F. Supp. 1185 (D. Minn. 1971).

100. For the Fourth Circuit, *Landreth* creates no change. The Fourth Circuit previously had rejected the doctrine, interpreting *Forman* to mean that the "economic realities" test applies only after the typical characteristics of stock fail to answer to the name appended. See *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); see also *Occidental Life Ins. Co. of North Carolina v. Pat Ryan & Assoc., Inc.*, 496 F.2d 1255, 1261 (4th Cir. 1974) (decided before *Forman* and applied a literal interpretation to the definition of "security").

101. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2306 (1985).

102. The Court's policy reasons involved the difficulty in ascertaining control, the linchpin of the "sale of business doctrine." The Court stated that line drawing would be inevitable and every case would turn on ascertaining control. *Landreth*, 105 S. Ct. at 2307. Additionally, the Acts' coverage would be unknown to the parties transacting business at sale time. *Id.* The Court also concluded that the slippery control factor may not surface until after extensive discovery. *Id.* at 2308.

literal approach to determine whether an instrument comes within the Acts' protection.¹⁰³ Language in *Landreth* indicates that the Court perceives circumstances whereby other expressly enumerated instruments could be excluded from the Acts' antifraud protection.¹⁰⁴ Thus, *Landreth* in no way means that the sale of business doctrine, as applied to notes or bonds for example,¹⁰⁵ will not withstand judicial scrutiny.

The decision in *Landreth* implicates only the fraud liability of those who seek to sell their business through a stock transfer. In reality, most of a closely held corporation's transactions involve securities exempt from the Acts' regulatory regime that requires the filing of a registration statement, prospectus, and other informational requirements of federal securities laws.¹⁰⁶ From a business planning standpoint, however, the *Landreth* decision alters strategy for those concerned with fraud liability. If the *Landreth* Court had decided the sale of a business effected through the transfer of stock was not a securities transaction, it would have made no difference whether the sale of business was consummated through stock or assets because, in either event, the legal recourse for a cause of action based on fraud would be state law. *Landreth* makes it clear that a sale of one's business through a stock transfer is a securities transaction. Thus, litigation conscious individuals seeking to dispose of their business now have a greater incentive to sell the company's assets to avoid possible liability under the Acts. By contrast, should fraud appear in a stock transaction, the import of *Landreth* enables an aggrieved buyer to receive his day in court in a federal forum.

The recrudescence of the literal interpretation of securities laws, at

103. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2306 n.7 (1985). The Court stated:

It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance. . . . [I]t is proper for a court to consider — as we do today — policy considerations in construing terms in these Acts.

Id. (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975)).

104. *Id.* The Court stated:

[N]ote[s] may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context. We here expressly leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.' We hold only that 'stock' may be viewed as being in a category by itself for purposes of interpreting the scope of the Acts' definition of 'security.'

Id. at 2307.

105. For an excellent discussion of whether a note is a "security," see Note, *The Economic Realities of Defining Notes As Securities Under the Securities Act of 1933 and The Securities Exchange Act of 1934*, 34 U. FLA. L. REV. 400 (1982).

106. R. HAMILTON, *THE LAW OF CORPORATIONS* 11 (1980) (NUTSHELL SERIES); Sargent, *State Limited and Private Offering Exemptions: The Maryland Experience in a National Perspective*, 13 U. BALT. L. REV. 496, 505-11 (1984).

least with respect to conventional stock, would make more sense if the *Landreth* Court's reasoning had encapsulated more of the ingenious arguments for excluding federal protection when a business is sold. Conspicuously absent in the Court's election to adopt the literal approach is the Court's failure to consider, as it did in *Marine Bank*, the vexatious five word phrase, "unless the context otherwise requires," prefacing the definition of security.¹⁰⁷ The *Landreth* Court was presented with the opportunity to interpret the meaning of this phrase but, instead, carefully sidestepped the issue. As a result, *Marine Bank* will continue to foster conjecture as to the applicability of that phrase to other instruments.¹⁰⁸

Moreover, the *Landreth* Court's superficial analysis of the Acts' legislative history ignores a crucial distinction between investor and entrepreneur. Investors, according to *Howey*, rent capital and expect to profit from the efforts of others.¹⁰⁹ The investor risks his capital in exchange for a return commensurate with the risk taken.¹¹⁰ Entrepreneurs, however, use capital that will enable them to be in business, and more significantly, profit from the sweat of their own brow. The entrepreneur combines the capital investment with management skills and innovative capabilities that will be used to benefit and control the company in which the capital is placed.¹¹¹ This very real distinction is summarily dismissed by the *Landreth* Court in its finding that the intent of certain provisions of the 1934 Act indicated that the Acts were intended to protect both the investor and the entrepreneur.¹¹² Yet, the legislative enactments cited by the

107. This phrase is not foreign to statutes. It appears in 36 other Congressional statutes. Brief for Appellant, Appendix B, *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297 (1985); see *supra* notes 53-58 and accompanying text.

108. See *supra* note 59 and accompanying text.

109. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

110. *Schneider, The Sale of a Business Doctrine - Another View*, 37 Sw. L.J. 461, 487 (1983).

111. See *Sutter v. Groen*, 687 F.2d 197, 201-02 (7th Cir. 1982).

112. See *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2305 (1985). But see S. REP. NO. 792, 73d Cong., 2d Sess. 2 (1934) (President Roosevelt's plea for enactment of 1934 Act to protect investors (emphasis supplied)); *id.* at 5 (report of the Senate Committee on Banking and Currency describing the goal of the legislation as minimizing speculation and secrecy concerning corporations "which invited the public to purchase their securities" (emphasis supplied)); *id.* at 4, 6-7, 11-12 (Senate Committee's Report contains references to "disastrous results to investors" and "tremendous losses to the investing public" (emphasis supplied)); H.R. REP. NO. 1838, 73d Cong., 2d Sess. 32-33 (1934) (indicating interests of the investor, not those who control a corporation, benefit from federal securities coverage); see also *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953) (purpose of 1933 Act "is to protect investors by promoting full disclosure of information"); *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 26 (10th Cir. 1972) (purpose of Acts is "the protection of investors from fraudulent practices"); *Hanna & Turlington, Protection of the Public Under the Securities Exchange Act*, 21 VA. L. REV. 251, 276 (1935) (Acts' purpose is to "improve the position of the average investor" (emphasis supplied)); Note, *Legislation: The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1223 (1933) (purpose is to enforce "disclosure to the investor of the elements necessary to insure an intelligent and informed judgment").

Court¹¹³ were intended as safeguards designed to protect the investor from the quintessential strongarming that can occur when there exists a separation of ownership and control.¹¹⁴ Additionally, the Court's conclusion on this point precedes its acknowledgement that Justice Stevens, in dissent,¹¹⁵ correctly asserts that the legislative history is dead silent as to transactions like the one in *Landreth*.¹¹⁶ The Court finesses the issue by stating that its appropriate recourse is to add policy considerations to aid the interpretation of legislative history.¹¹⁷ The policy consideration was to make both buyer and seller aware at the time of the sale of the business that the transaction was covered by the Act, thereby eviscerating the importance of the control factor and, according to the Court, eviscerating the concomitant laborious fact-finding mission that each court must engage in to divine the passage of control.¹¹⁸

The Court in *Landreth* properly laid to rest the fiction that "stock" is not a "security," and firmly established that the *Howey* test would be applicable only to investment contracts. A much broader problem created by *Landreth*, however, is the Court's imprimatur upon aggrieved buyers of closely held corporations, conducting their deals in typically face-to-face fashion, to resolve their fraud claims in federal forums. This policy issue, essentially a question of federalism, can be narrowed to whether buyers of securities in a closely held corporation should be entitled to have the more favorable federal remedy of fraud rather than the common law tort of fraud. Significantly, the latter remedy usually makes omissions of fact unactionable.¹¹⁹ If these potential plaintiffs deserve

113. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2305 (1985). The Court stated: "The 1934 Act contains several provisions specifically governing tender offers, disclosure of transactions by corporate officers and principal stockholders, and the recovery of short-swing profits gained by such persons." *Id.*

114. With respect to tender offers, disclosure requirements were enacted so that shareholders can decide with prescience whether or not to tender their shares. See HENN & ALEXANDER, *LAW OF CORPORATIONS* 820 (3d ed. 1983). Regarding the statutory prohibitions against insider trading, section 16(b) of the 1934 Act provides that a director, officer, or ten percent beneficial owner who purchases and sells, or sells and purchases the stock of his corporation within a period of less than six months is liable to the corporation for any profits obtained. 15 U.S.C. § 78p(b) (1982). Commentators have concluded that the thrust of section 16 is to protect the investor from those running the company. See, e.g., Cook & Feldman, *Insider Trading Under the Securities Exchange Act* (pts 1-2), 66 HARV. L. REV. 612, 641 (1953) ("It is to be expected that [section 16] will continue to be an important and secure link in the armor protecting the public investor."); Rubin & Feldman, *Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 468 (1947) ("The invidious character of such trading is emphasized by the fact that the profit so obtained by the managers was not disclosed to the real owners of the corporation, to wit, the stockholders, and because it was often obtained at their expense.").

115. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2312-13 (1985) (Stevens, J., dissenting).

116. *Id.* at 2306 n.7.

117. *Id.*

118. See *supra* notes 94-97 and accompanying text.

119. See Long, *Don't Forget the Securities Acts!*, 26 OKLA. L. REV. 160, 181 (1973)

more protection than common law fraud provides, the appropriate remedy then would be to enact a state law parallel to rule 10b-5. It makes no sense for federal forums to be forced to deal with the kinds of problems that involve close corporation shares that are rarely traded. These problems are better left to state securities laws or state common law fraud. Moreover, making rule 10b-5 applicable to the close corporation contravenes the rule's purpose, which is to protect the investor investing in public securities.¹²⁰ Relying on the rule's purpose, commentators have argued that rule 10b-5 and the other federal antifraud rules do not belong amid the affairs of closely held companies because close corporation shares are infrequently traded.¹²¹ Because *Landreth* dismissed the novel argument that a closely held corporation's stock, when used to transfer ownership and control, is not a security, it is incumbent upon Congress to exempt transactions involving the sale of a closely held corporation negotiated face-to-face from rule 10b-5. Congress first must make the determination that abatement of federal regulation in this area is necessary, that rule 10b-5 need not "cover the corporate universe," and that regulation is better left to the state regulatory mechanism. Congress should then pick up where the "sale of business doctrine" left off and render the federal antifraud rules inapplicable to the closely held corporation. This legislative action would serve to end the unnecessary intrusion by the federal government into matters better resolved by the states.

In sum, *Landreth* provides a much needed clarification of the applicability of the sale of business doctrine and the applicability of the *Howey* test to instruments other than investment contracts. The practical realities, however, of *Landreth* beg Congressional action to exclude from federal antifraud protection a stock transfer involving the sale of a closely held corporation.

Jeff Cook

("[T]he question of whether common law fraud will cover omissions as well as fraudulent statements is eliminated. It is clear from the language of . . . the Federal Acts that one cannot escape liability by failing to disclose material information.").

120. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974). Professor Cary, an ardent supporter of federal securities regulation, said in regard to rule 10b-5: "It seems anomalous to jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are presently written." *Id.*
121. E.g., Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 LAW & CONTEMP. PROBS. 505 (1953); Mofsky, *Some Comments on the Expanding Definition of "Security,"* 27 U. MIAMI L. REV. 395 (1973); Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947 (1976); Note, *A New Approach to Rule 10b-5: Distinguishing the Close Corporation*, 1978 WASH. U.L.Q. 733.