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Definition of a Security: Landreth Timber Co. v. Landreth

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DEFINITION OF A SECURITY: *LANDRETH TIMBER CO. V. LANDRETH*

IN 1977 Ivan Landreth and his two sons offered to sell their business, Landreth Timber Company. Samuel Dennis and John Bolten subsequently purchased the timber company. The sale involved the transfer of one hundred percent of Landreth Timber Company's stock to B&D Company, a corporation the buyers formed to purchase the timber company.[1] The business soon proved unsuccessful and went into receivership. Landreth Timber Company then filed suit against the Landreths, the sellers, in the federal court for the Western District of Washington claiming damages of $2,500,000 for violations of the fraud and civil liability provisions of the Securities Act of 1933[2] and the misrepresentation and fraud provision of the Securities Exchange Act of 1934.[3]

The trial court granted the defendants' motion for a summary judgment, and the Ninth Circuit affirmed, finding that the stock at issue failed to meet the statutory definition of a security and thus was not entitled to the protection of the securities laws.[4] The Ninth Circuit reasoned that a sale of one hundred percent of a company's stock is not a transaction involving a security because the purchaser is not a true investor, but an owner of the business through the transfer of control.[5] An investor relies on the efforts of others to make a profit, while an owner relies on his own efforts to make a profit.[6] Before *Landreth* this concept, commonly known as the sale of business doctrine, had caused a split among the circuit courts.[7] To settle the issue the

1. Rather than a simple sale of the company's assets, Ivan Landreth required the purchasers to buy the company's stock.

2. Securities Act of 1933, §§ 12(2), 17(a), 15 U.S.C. §§ 77*l*(2), 77q(a) (1982).

3. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j(b) (1982).

4. Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1349, 1353 (9th Cir. 1984). The 1933 Act defines a security quite broadly through an extensive list of investment devices that includes stock. Securities Act of 1933, § 2, 15 U.S.C. § 77b(1) (1982). This section contains a clause that prevents any of the investment devices listed from being termed a security if the context in which the device is used so warrants. *Id.* § 2, 15 U.S.C. § 77b. The definition of a security within the context of the 1934 Act is essentially the same. Securities Exchange Act of 1934, § 3, 15 U.S.C. § 78c(a)(10) (1982); *see* Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967); *see also infra* note 14 and accompanying text (discussing definition of security under the Acts).

5. 731 F.2d at 1351-52; *see* SEC v. W.J. Howey Co., 328 U. S. 293, 301 (1946).

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

7. The Seventh, Tenth, and Eleventh Circuits had previously held that a sale of stock did not constitute a security when accompanied by a transfer of control. *See* Christy v. Cambron,

Supreme Court granted certiorari. *Held, reversed*: If an instrument possesses the label and traditional characteristics of stock, it constitutes a security within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934, and an analysis of the underlying transaction is unnecessary. 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985).

I. DEFINITION OF SECURITY UNDER THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

The definitions of the regulated securities under the Securities Act of 1933 and the Securities Exchange Act of 1934 are essentially the same.[8] Indeed, the Supreme Court has treated the definitions as identical when determining whether particular instruments are included in the respective definitions.[9] Congress passed the Acts in response to the 1929 stockmarket crash[10] to restore the investing public's confidence in the financial markets.[11] To achieve this goal, Congress focused its concern on regulation of the securities exchanges and over-the-counter markets.[12] An examination of the legislative cupboard, however, for the drafters' intended meaning of the term "security" reveals little.[13] The statutes contain no more than a laundry list stating that, unless the "context" requires otherwise, a security includes, inter alia, any note, stock, bond, investment contract, mineral royalty or lease, certificate of deposit, or option.[14] The only other guideline offered is that the

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710 F.2d 669, 672 (10th Cir. 1983); Sutter v. Groen, 687 F.2d 197, 202 (7th Cir. 1982); King v. Winkler, 673 F.2d 342, 345 (11th 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); Chandler v. Kew, Inc., 691 F.2d 443, 444 (10th Cir. 1977) (opinion ordered published 1982). The Second, Third, Fourth, and Fifth Circuits had previously rejected the sale of business doctrine. *See* Daily v. Morgan, 701 F.2d 496, 499 (5th Cir. 1983); Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227, 229 (2d Cir. 1982); Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982); Glick v. Campagna, 613 F.2d 31, 35 n.3 (3d Cir. 1979) (literal reading of Act requires rejection of sale of business doctrine); Occidental Life Ins. Co. v. Pat Ryan Assocs., 496 F.2d 1255, 1261 (4th Cir. 1974).

8. For the definition of a security under the Acts see *infra* note 14.

9. *See* Landreth Timber Co. v. Landreth, 105 S. Ct. 2297, 2302 n.1, 85 L. Ed. 2d 692, 697 n.1 (1985) (citing 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 (1967).

10. *See* Easley, *Recent Developments in the Sale-of-Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 BUS. LAW. 929, 932 (1984); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 613 (1964); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

11. *See* Marine Bank v. Weaver, 455 U.S. 551, 555 (1982); H. BLOOMENTHAL, CASES & MATERIALS ON SECURITIES LAW 9 (1966); M. PARRISH, SECURITIES REGULATION & THE NEW DEAL 43 (1970); Easley, *supra* note 10, at 932; 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, 234-35 (1982).

12. *See* Daily v. Morgan, 701 F.2d 496, 500 (5th Cir. 1983).

13. *See* Easley, *supra* note 10, at 950 n.166; Knauss, *supra* note 10, at 613; Landis, *supra* note 10, at 29; Note, *Repudiating the Sale-of-Business Doctrine*, 83 COLUM. L. REV. 1718, 1728 (1983); *see also* M. PARISH, *supra* note 11, at 113 (origin of 1934 Act unclear).

14. The Securities Act of 1933, § 2, 15 U.S.C. § 77b(1) (1982) provides:

> When used in this title . . . unless the context otherwise requires—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture,

definition of a security should be broadly construed to include those instruments and devices commonly referred to and thought of as a security.[15]

Because Congress failed to describe the characteristics that distinguish securities from nonsecurities, courts have fashioned their own concepts of what the definitions cover. Courts that have embraced the sale of business doctrine limit the Acts' coverage to instruments held by true investors and exclude from coverage instruments held by entrepreneurs.[16] Courts that have rejected the sale of business doctrine argue that Congress intended the definition of security to include stock received in the sale of a business even though a transfer of control accompanied the stock transfer.[17] These courts do not view the terms investor and entrepreneur as mutually exclusive.[18]

> evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust 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.

The Securities Exchange Act of 1934, § 3, 15 U.S.C. § 78c(a)(10) (1982) provides:

> When used in this title, unless the context otherwise requires—
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> . . . .
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> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15. H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933); *see* Marine Bank v. Weaver, 455 U.S. 551, 555-56 (1982); 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); Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982); Easley, *supra* note 10, at 932, 950 n.166; Thompson, *supra* note 11, at 230; Note, *supra* note 13, at 1728.

16. *See* Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983); Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982); King v. Winkler, 673 F.2d 342, 344-45 (11th Cir. 1982); Frederiksen v. Poloway, 637 F.2d 1147, 1150 (7th Cir. 1981). These cases distinguished investors from entrepreneurs by focusing on whether the buyer gains control over his purchase. *See* Thompson, *supra* note 11, at 235-36, 240-41. If he has, the purchaser is not an investor. *Id.* An investor relies on others for potential profit. *Id.*

17. *See* Daily v. Morgan, 701 F.2d 496, 500-04 (5th Cir. 1983); Golden v. Garafalo, 678 F.2d 1139, 1145 (2d Cir. 1982); *see also* Note, *supra* note 13, at 1725 (Congress intended that courts should examine instrument, not transaction).

18. *See* Ruefenacht v. O'Halloran, 737 F.2d 320, 334 (3d Cir. 1984); Golden v. Garafalo, 678 F.2d 1139, 1146 (2d Cir. 1982); Note, *supra* note 13, at 1738-39; *see also* Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982) (purchaser may be both investor and entrepreneur). *But see* Thompson, *supra* note 11, at 240 (investment buyer makes not type of investment protected under Acts).

II. DEFINITION OF SECURITY: FLESHING IT OUT IN THE COURTS

In *SEC v. C.M. Joiner Leasing Corp.*[19] the Supreme Court for the first time delved into the intricacy of what constitutes a security under the Acts.[20] At issue in *Joiner* were various leasehold interests in land adjacent to proposed oil well sites. The Court held that the unusual leasehold instruments involved constituted investment contracts entitled to the protection of the Acts.[21] The Court observed that the Acts' coverage extended beyond the familiar concepts of a security.[22] The Court refused to accept that an instrument must wear one of the labels contained in the definition of security to receive treatment as a security under the Acts.[23] Nevertheless, the Court suggested that a literal reading of the definition required the inclusion of the leasehold interests within the definition of "security."[24] Labels such as stock, note, or bond on the face of an instrument could bring an instrument such as a leasehold interest within the definition of security.[25]

Only three years later the Court decided *SEC v. W.J. Howey Co.*[26] This case involved the sale of units of citrus grove acreage coupled with an optional service contract for cultivating and marketing the fruit and returning the net proceeds of the fruit sales to the buyer. Although optional, the vast majority of buyers chose the service contract because they had no background in caring for citrus trees. The lure of substantial profits attracted buyers who typically bought little more than one acre.[27] Examining the substance of the offer instead of its form, the Court found that the service contract at issue constituted an investment contract covered by the scope of the definition of "security."[28] The Court formulated a test the vitality of which remains unabated: An investment scheme falls under the Acts' definition of security if the scheme involves investment of money in a common enterprise the profits of which result solely from the labor of others.[29] The facts of *Howey* clearly met this test. The *Howey* test reflected a dynamic principle designed to protect investors from the boundless schemes created by those

19. 320 U.S. 344 (1943).

20. *Id.* at 345.

21. *Id.* at 351.

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.* at 355. In United Hous. Found., Inc. v. Forman, 421 U.S. 837, 850 (1975), the Supreme Court characterized as dictum the *Joiner* Court's conclusion that a more general type of interest could fit one of the specific labels of the Acts.

26. 328 U.S. 293 (1946).

27. *Id.* at 296. The defendant, W.J. Howey Co., represented to buyers that returns of over 20% were possible.

28. *Id.* at 299.

29. *Id.* at 301. The Court based this test on state court interpretations of investment contracts under local blue-sky laws. *See* People v. White, 124 Cal. App. 548, 12 P.2d 1078, 1081 (1932); State v. Evans, 154 Minn. 95, 191 N.W. 425, 426-27 (1922); Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 161 A. 193, 195 (Ch. 1932); State v. Heath, 199 N.C. 135, 153 S.E. 855, 857-58 (1930); Klatt v. Guaranteed Bond Co., 213 Wis. 12, 250 N.W. 825, 827-29 (1933).

hoping to attract investors' money through the lure of profits.[30]

Courts that endorsed the sale of business doctrine managed to use the *Howey* test to support their position. Those courts argued that if the buyer purchased one hundred percent of the transferring company's stock, he could not meet the first condition of the test, investment in a common enterprise.[31] Ownership of all of the stock precluded having an enterprise in common with others.[32]

The Court continued to expand the definition of security in *Tcherepnin v. Knight*.[33] That case considered whether the definition of security included withdrawable capital shares in a savings and loan. Employing the *Howey* test, the Court held that the shares constituted securities.[34] The shares fell within the test's scope since the shareholders participated in the common enterprise of money lending, the success of which depended upon the business acumen of the savings and loan's managers.[35] The shareholders could anticipate a return on their investment only if the savings and loan proved profitable because Illinois state law conditioned the payment of dividends on withdrawable capital shares upon an apportionment of profits.[36] The *Knight* Court became the first court to include in its definitional analysis the prefatory clause to the Acts' definition of security, "unless the context otherwise requires."[37]

Supporters of the sale of business doctrine emphasized the prefatory clause.[38] They viewed "context" as referring to the transaction in which a security was exchanged and felt that a transaction involving the sale of a company was a context that did not require invocation of the Acts.[39] Opponents saw "context" as referring to the use of the term "security" in other statutes.[40]

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30. 328 U.S. at 299. The *Howey* test brought many investment schemes within the scope of the Acts. *See* Thompson, *supra* note 11, at 231; Note, *supra* note 13, at 1729.

31. Canfield v. Rapp & Son, Inc., 654 F.2d 459, 464 (7th Cir. 1981); *accord* Chandler v. Kew Inc., 691 F.2d 443, 444 (10th Cir. 1977) (opinion ordered published 1982) (securities laws failed to protect purchaser of company who also bought the company's stock because stock was mere indicia of ownership); Seagrave Corp. v. Vista Resources, Inc., 534 F. Supp. 378, 384 (S.D.N.Y. 1982) (plaintiffs failed to recover because they alone had a financial stake in the purchased company); Anchor-Darling Indus. v. Suozzo, 510 F. Supp. 659, 663 (E.D. Pa. 1981) (plaintiff who relied on himself for profits did not fall under protection of the Securities Acts).

32. Courts also found no common enterprise in cases where the seller received an employment contract or an override interest. *See* Frederiksen v. Poloway, 637 F.2d 1147, 1152 (7th Cir. 1981); Barsy v. Verin, 508 F. Supp. 952, 958 (N.D. Ill. 1981).

33. 389 U.S. 332, 334-35 (1967).

34. *Id.* at 338-39.

35. *Id.* at 338.

36. *Id.* at 338-39.

37. *Id.* at 335; *see supra* note 14.

38. *See* Frederiksen v. Poloway, 637 F.2d 1147, 1150-52 (7th Cir. 1981); *see also* Thompson, *supra* note 11, at 251-52 (sale of business doctrine need not rely on prefatory clause due to traditional principles of statutory interpretation). *But see* SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969) (prefatory clause refers to the context of security as used in other statutes); Note, *supra* note 13, at 1726 (prefatory clause used to escape bizarre applications of the Acts).

39. *See* Frederiksen v. Poloway, 637 F.2d 1147, 1150 (7th Cir. 1981); Seagrave Corp. v. Vista Resources, Inc., 534 F. Supp. 378, 384 (S.D.N.Y. 1982); Golden v. Garafalo, 521 F. Supp. 350, 358 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

40. *See* Note, *supra* note 13, at 1728 n.71.

Joiner, *Howey*, and *Knight* demonstrated the Court's desire to construe the Acts' definition of security broadly. Not until 1975, in *United Housing Foundation, Inc. v. Forman*,[41] did the Court narrow its view. *Forman* involved the transfer of what at first glance appeared a traditional security, shares of stock in a nonprofit housing cooperative. Purchase of the shares entitled the buyer to lease low-cost apartments.

The Court engaged in a bifurcated analysis. The first section of the Court's opinion examined whether labeling an instrument as stock created protection for the transaction under the Acts. The second part of the analysis considered whether the instrument fell within the definition of an investment contract or other instrument generally known as a security. The Court answered "no" to both questions.[42]

The Court, relying on the substance over form doctrine,[43] declined to find that the label "stock" afforded to the sale of the housing cooperative shares protection under the securities laws.[44] The Court argued that the economic realities behind the transaction, not the instrument's label, invoke the protection of the Acts since securities transactions are economic by nature.[45] The spirit of the statute might exclude a term explicitly included in the language of the statute.[46]

Backing up a step, the Court explained that an instrument's label does have some relation to the definition of security.[47] A traditional label, in some circumstances, might cause a buyer to believe that the securities laws protected him.[48] For example, if the underlying transaction incorporated several important attributes commonly related to instruments that are labeled in the same manner as legitimate securities, a buyer could mistakenly believe the Acts afforded him protection when in fact they did not.[49] The Court concluded that the purchasers in *Forman*, however, could not have thought that the Acts covered their transaction because the instrument had none of the traits commonly associated with stock.[50] Characteristics usually associated with stock included payment of dividends dependent upon profits, transferability, use as collateral, voting rights proportionate to the number of shares owned, and potential for appreciation.[51]

The second part of the two-step analysis, whether the instruments consti-

41. 421 U.S. 837 (1975).

42. *Id.* at 846-47. The Court prefaced its two-step analysis by referring to *Howey*, 328 U.S. at 293, as the guiding principle in this type of security analysis. *Forman*, 421 U.S. at 848.

43. The substance over form doctrine disregards the form of the transaction and focuses instead on the actual economic consequences of the transaction. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

44. 421 U.S. at 848.

45. *Id.* at 849.

46. *Id.* The Court rejected the tenants' reliance on *Joiner*. *Id.* The *Joiner* Court's use of conditional language showed that the Court would inquire into the transaction's economic substance when necessary. 320 U.S. at 351, 355.

47. 421 U.S. at 850.

48. *Id.*

49. *Id.*

50. *Id.* at 851.

51. *Id.*

tuted investment contracts or instruments commonly known as securities, focused once again on the transaction's economic realities and not the label.[52] Further, the Court, for analytical purposes, equated an investment contract with an instrument commonly known as a security.[53] Applying the *Howey* test, the Court found that the housing cooperative scheme attracted buyers only to a place to live, not to expected profits.[54] Thus, the stock at issue did not fall within the definition of security.[55] At the opinion's conclusion the Court restated the *Howey* test, but substantially altered the third part of the test. Anticipated profits no longer needed to come solely from the efforts of others; the investor himself could participate in generating profits so long as he also relied on the efforts of others.[56]

Lower courts used *Forman* as a catalyst to give birth to the sale of business doctrine.[57] These courts saw *Forman* as endorsing an examination of the economic reality of a stock sale in all instances.[58] If economic reality demonstrated that the sale of stock was merely a byproduct of the sale of a business, the securities laws did not apply.[59] Proponents of the sale of business doctrine also used the third element of the *Howey* test, as modified by *Forman*,[60] to exclude some stock sales from the Acts' coverage.[61] A purchaser who in reality buys control of a business does not rely on the efforts of others to produce a profit.[62] Furthermore, some courts interpreted the modification of the *Howey* test to imply that the Acts would not come into play in transactions in which the purchaser did not buy all of the business's stock,

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52. *Id.* at 851-52.

53. *Id.* at 852. One commentator found this comparison significant because stock constitutes an instrument commonly considered as a security. Thus, the *Howey* test applied equally to stock transactions. Seldin, *When Stock Is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637, 667 (1982).

54. 421 U.S. at 853.

55. *Id.* at 854.

56. *See id.* at 858.

57. *See* Sutter v. Groen, 687 F.2d 197, 199-200 (7th Cir. 1982); King v. Winkler, 673 F.2d 342, 345-56 (11th Cir. 1982); Chandler v. Kew, Inc., 691 F.2d 443, 443-44 (10th Cir. 1977) (opinion ordered published 1982) (first case to approve sale of business doctrine).

58. *See* Canfield v. Rapp & Son, Inc., 654 F.2d 459, 464 (7th Cir. 1981); Frederiksen v. Poloway, 637 F.2d 1147, 1150-51 (7th Cir. 1981); Reprosystem v. SCM Corp., 522 F. Supp. 1257, 1274 (S.D.N.Y. 1981); Golden v. Garafalo, 521 F. Supp. 350, 356-57 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982); Zilker v. Klein, 510 F. Supp. 1070, 1075 (N.D. Ill. 1981); Anchor-Darling Indus. v. Suozzo, 510 F. Supp. 659, 665 (E.D. Pa. 1981); Barsy v. Verin, 508 F. Supp. 952, 957-58 (N.D. Ill. 1981); Tech Resources, Inc. v. Estate of Hubbard, 246 Ga. 583, 272 S.E.2d 314, 316 (1980); *see also* Seldin, *supra* note 53, at 665-68 (excerpts from and composition of *Forman* suggest examination of economic reality in any exchange).

59. *See* Chandler v. Kew, Inc., 691 F.2d 443, 443-44 (10th Cir. 1977) (opinion ordered published 1982).

60. *Forman* modified *Howey* by deleting the requirement that profits be earned solely through the efforts of third parties. 421 U.S. at 852; *see supra* text accompanying note 56.

61. *Forman* deleted the word "solely" from the third component of the *Howey* test. 421 U.S. at 858.

62. *See, e.g.*, Somogyi v. Butler, 518 F. Supp. 970, 984 (D.N.J. 1981) (purchaser of 90% of company's stock does not receive protection under the Acts); Anchor-Darling Indus. v. Suozzo, 510 F. Supp. 659, 663 (E.D. Pa. 1981) (purchaser of controlling interest cannot claim protection of the Acts).

but received the right to control the business's operations.[63] This interpretation found its basis in that the Acts sought to protect people who had little or no control over their investment. Therefore, those who could exert control over their investment fell outside the purview of the Acts.

Courts that refused to accept the sale of business doctrine also used *Forman* for support.[64] They interpreted *Forman* as requiring a transaction analysis only if the label of the instrument failed to match the standard characteristics of such an instrument.[65] The Supreme Court would not have engaged in a two-step analysis if the economic realities test always applied.[66] Therefore, the sale of typical stock invoked coverage under the Acts because the definition of security included stock.[67] Opponents of the doctrine also disagreed with the pro-doctrine courts' interpretation of the third part of the *Howey* test. They felt that an analysis of control imposed an unnecessary and unnatural hardship on interpretation of the Acts.[68] These courts found it unnatural that a purchaser of a fifty-one percent block of shares would not receive the Acts' protection, while a forty-nine percent purchaser would.

The Court continued to narrow the Acts' scope in *Marine Bank v. Weaver*,[69] a case that once again brought the issue of the definition of security before the Court. The case involved the Weavers' purchase of a certificate of deposit from Marine Bank and their subsequent pledge to Marine Bank to guarantee a loan made by Marine to a meat company in exchange for a fifty percent net profits interest in the company. The opinion acknowledged that the definition of security covered a wide range of instruments, but noted that the prefatory clause affected the statute's interpretation.[70] The Acts did not presume to protect all instruments from fraud.[71] The Supreme Court rejected the Third Circuit's finding that a certificate of deposit resembled the instrument found to be a security in *Knight*.[72] Applying the prefa-

63. *See* Frederiksen v. Poloway, 637 F.2d 1147, 1152-53 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); Barsy v. Verin, 508 F. Supp. 952, 957-58 (N.D. Ill. 1981).

64. One commentator recognized that language in *Forman* created dueling passages. Seldin, *supra* note 53, at 665.

65. Daily v. Morgan, 701 F.2d 496, 499 (5th Cir. 1983); Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982); Coffin v. Polishing Machines, Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Glick v. Campagna, 613 F.2d 31 (3d Cir. 1978); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 335-36 (W.D. Pa. 1980); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 449 (D. Colo. 1978); Bronstein v. Bronstein, 407 F. Supp. 925, 926 (E.D. Pa. 1976).

66. *See* Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982) (shares of housing project not securities regardless of economic reality test).

67. Advocates of the sale of business doctrine argued that the holding of the lower court forced the Supreme Court to engage in the bifurcated approach instead of applying the transaction analysis alone. *See id.* at 1148 (Lumbard, J., dissenting); Easley, *supra* note 10, at 949 n.164, 961-62; Seldin, *supra* note 53, at 667-68.

68. *See* Daily v. Morgan, 701 F.2d 496, 503-04 (5th Cir. 1983); Golden v. Garafalo, 687 F.2d 1139, 1146 (2d Cir. 1982); Occidental Life Ins. v. Pat Ryan & Assocs., 496 F.2d 1255, 1263 (4th Cir. 1974); Note, *supra* note 13, at 1737-44.

69. 455 U.S. 551 (1982).

70. *Id.* at 556. The Court first considered the prefatory clause for analytical purposes in Tcherepnin v. Knight, 389 U.S. 332, 335 (1967).

71. 455 U.S. at 556 (citing Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1255-60 (9th Cir. 1976)).

72. *Knight* involved withdrawable capital shares in a savings and loan. *Knight* differed

tory clause, the majority found that the federal banking laws provided a context in which the securities laws should not apply.[73] The guarantee of payment by the Federal Deposit Insurance Corporation provided enough protection so as to preclude coverage by the Acts.[74]

The Supreme Court also rejected the Third Circuit's finding that the business agreement in *Marine Bank* constituted a security. The particular nature of the agreement differed from the instruments usually thought of as securities.[75] Not only did the agreement fall outside the category of a typical security, but the majority distinguished the agreement from the instruments in *Joiner* and *Howey* that were classified as securities.[76] The Court noted that the instruments in *Joiner* and *Howey* had the same values to most people and could have been sold publicly.[77] The unique qualities of the agreement in *Marine Bank* prohibited it from being publicly exchanged.[78] Moreover, unlike the *Joiner* and *Howey* instruments, the Weavers received no prospectus prior to the agreement.[79] The Court also found the control given by the agreement uncharacteristic of a security.[80] Finally, the Court mentioned the equal bargaining strength of the parties to the agreement.[81] These factors justified finding that the agreement was not a security.[82]

Advocates of excepting from the Acts' coverage stock sales of businesses accompanied by transfers of control were delighted with the Court's holding in *Marine Bank*.[83] The manner in which the Court used the prefatory clause supported the context of the transaction position and rejected the statutory context approach.[84] Furthermore, sales of businesses normally involve equal bargaining strength, a position that the *Marine Bank* Court found determinative in excepting the transaction in that case from coverage of the Acts.[85] Sale of business doctrine proponents considered a certificate of deposit as a type of note.[86] Since the Court examined the reality of the transaction for an

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from *Marine Bank* because the capital shares purchasers received voting rights and dividends, not a fixed interest rate. *Marine Bank*, 455 U.S. at 557.

73. *Id.* at 558-59.

74. *Id.* at 558. The Court differentiated certificates of deposit from notes on the basis of risk. Notes possessed a higher risk of default than certificates of deposit.

75. *Id.* at 559-60. A provision permitting the respondents to use the barn and grazing land of the meat company reflected the uniqueness of the agreement.

76. Unlike *Joiner* and *Howey*, the meat company did not offer this transaction to a number of potential investors. *Id. Joiner* involved the mailing of more than one thousand prospectuses. *Howey* had forty-two investors.

77. *Id.* at 560.

78. *Id.*

79. *Id.* at 559-60.

80. *Id.* at 560.

81. *Id.*

82. *Id.*

83. *See* Sutter v. Groen, 687 F.2d 197, 200 (7th Cir. 1982).

84. *See id.*; Easley, *supra* note 10, at 945. *But see* Note, *supra* note 13, at 1727-28 (transaction approach to clause stretches clause too far because Congress merely meant clause to prevent bizarre uses of the Acts).

85. *See Marine Bank*, 455 U.S. at 560; Easley, *supra* note 10, at 946.

86. *See* Sutter v. Groen, 687 F.2d 197, 200 (7th Cir. 1982); Easley, *supra* note 10, at 944. *But see Marine Bank*, 455 U.S. at 558; Note, *supra* note 13, at 1733 (note does not include certificate of deposit because federal banking laws protect the purchaser).

instrument included within the definition of security, a "note," then stock purchases should receive the same sort of reality of the transaction analysis because "stock" is also listed in the definition of security.[87]

III. *LANDRETH TIMBER CO. V. LANDRETH*

In *Landreth Timber Co. v. Landreth* the Court held that stock possessing typical characteristics of stock plainly fell within the statutory definition of security.[88] The opinion, authored by Justice Powell, noted that previous Supreme Court opinions did not preclude establishing an instrument as a security through an examination of the instrument's label and characteristics.[89] Furthermore, policy reasons concerning the uncertainty of the Acts' protection supported the Court's holding. Purchasers of typical stock would expect federal protection,[90] and exclusion of the type of transaction involved in the case would deleteriously affect other sections of the Acts.[91]

The Court began its substantive analysis with a truism: statutory interpretation begins with the written words.[92] In its analysis of the literal meaning of the definition of security, the Court set forth the 1933 Act's definition of security, but notably failed to include the prefatory clause, "unless the context otherwise requires."[93] The statutory provision plainly demonstrated that the definition of security included stock. The appellation "stock," however, did not require the protection of the securities laws according to *Forman*.[94] *Forman* required examination of whether the instrument had important traits normally connected with stock.[95]

The Court then mentioned a policy consideration. Purchasers of an instrument labeled "stock" might rightfully assume that they enjoyed the Acts' protection when the instrument possessed typical attributes of stock.[96] According to the Court, five traits typify an instrument as common stock: a right to dividends conditioned upon a distribution of earnings; transferability; the ability to be used as collateral; voting rights proportionate to amount

87. *See* Easley, *supra* note 10, at 959; Seldin, *supra* note 53, at 669-70. *But see* Daily v. Morgan, 701 F.2d 496, 498 (5th Cir. 1983) (*Marine Bank* supports position of doctrine opponents as well as advocates).

88. 105 S. Ct. at 2303, 85 L. Ed. 2d at 698. The Court previously noted the issue presented in *Landreth*, but failed to address it. Scherk v. Alberto-Culver Co., 417 U.S. 506, 521 (1974) (Douglas, J., dissenting); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13-14 n.10 (1971).

89. 105 S. Ct. at 2304, 85 L. Ed. 2d at 700.

90. *Id.* at 2306, 85 L. Ed. 2d at 702.

91. *Id.* at 2305, 85 L. Ed. 2d at 701.

92. *Id.* at 2301, 85 L. Ed. 2d at 696-97.

93. Securities Act of 1933, § 2, 15 U.S.C. § 77b (1982). Sale of business advocates used the clause as a basis for their position.

94. 421 U.S. at 848.

95. *Landreth*, 105 S. Ct. at 2302, 85 L. Ed. 2d at 697 (citing *Forman*, 421 U.S. at 851). The Court ignored *Forman*'s analysis of the underlying transaction. 105 S. Ct. at 2302, 85 L. Ed. 2d at 697. This disregard of the complete *Forman* analysis foreshadowed the Court's holding.

96. 105 S. Ct. at 2302, 85 L. Ed. 2d at 697; *accord* Daily v. Morgan, 701 F.2d 496, 500 (5th Cir. 1983).

of shares held; and the potential to increase in value.[97]

The majority effectively used these five traits to distinguish *Landreth* from *Forman*. The purchasers in *Forman* could not have thought that they had bought a security since the stock possessed none of the typical characteristics of common stock and the purchasers bought the stock in order to obtain housing for their own use.[98] In *Landreth* the parties did not dispute that the stock had the five typical stock traits.[99] Also, unlike *Forman*, the facts of *Landreth*, the sale of stock of a corporation, seemed to fit the context of the Acts' definition.[100] The Court echoed its concern that an investor would think his purchase fell within the scope of the Acts.[101] The language of the definition coupled with the policy concerns required finding that the stock in *Landreth* constituted a security.[102]

Although the statutory analysis suggested judgment in favor of the petitioner timber company,[103] the Court discussed the arguments of the respondents and the lower court. The respondents, the Landreths, argued that *Forman*, *Knight*, and *Marine Bank* all required an inquiry into the economic reality of the exchange to resolve whether, under the *Howey* test, the definition of security included the stock instrument at bar.[104] The respondents further reasoned that the petitioners failed to meet the third condition of the *Howey* test because the purchase brought with it control of the company.[105] Congress, they argued, intended to protect transactions involving inactive investors, not confidential transactions involving entrepreneurs who would control the operations of the business themselves rather than rely on others.[106] The respondents' argument seemed to liken entrepreneurs to the *Forman* purchasers who controlled and used their homes and did not receive the protection of the Acts.

The Court found three distinct faults with the respondents' arguments. First, the Court held that the cases the respondents relied on all involved atypical instruments not normally classified as securities.[107] The economic

97. 105 S. Ct. at 2302, 85 L. Ed. 2d at 697-98. The Court first identified these traits in *Forman*, 421 U.S. at 851.

98. *Landreth*, 105 S. Ct. at 2302, 85 L. Ed. 2d at 698.

99. *Id.* at 2302-03, 85 L. Ed. 2d at 698. One advocate of the sale of business doctrine argues that all purchasers buy stock for their own use. Thompson, *supra* note 11, at 243. *But see* Note, *supra* note 13, at 1737-38 (buyers of businesses purchase with a hope for profits, other buyers consume their purchases).

100. 105 S. Ct. at 2303, 85 L. Ed. 2d at 698.

101. *Id.*; *see id.* at 2302, 85 L. Ed. 2d at 697.

102. *Id.* at 2303, 85 L. Ed. 2d at 698. The Court saw its reading of the Acts in harmony with Congress's purpose of guarding investors. The Court acknowledged that the Acts did not cover all fraud. *See supra* note 71 and accompanying text. Nevertheless, to exclude the stock in *Landreth* would unjustifiably limit the expansive definition of security. Note, *supra* note 13, at 1730.

103. The Court cited L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 212 (1983) as an authority for the proposition that a statutory examination alone is adequate. 105 S. Ct. at 2303 n.3, 85 L. Ed. 2d at 698 n.3.

104. 105 S. Ct. at 2304, 85 L. Ed. 2d at 699-700.

105. *Id.* at 2306-07, 85 L. Ed. 2d at 703.

106. *See id.*; Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982).

107. 105 S. Ct. at 2304, 85 L. Ed. 2d at 700. In a footnote the Court questionably labeled the certificate of deposit in *Marine Bank* as an unusual instrument. *Id.* n.4.

substance behind the exchange provided the only vehicle to prove those instruments fell within the typical conception of a security.[108] The instrument in this case did not require an analysis beyond its characteristics to determine whether it constituted a security because traditional stock came clearly within the definition of security.[109] The majority stated that previous opinions had not eliminated the likelihood that stock would constitute a security if it possessed traditional qualities.[110]

The Court also attacked the respondents' understanding of the *Howey* test. That test involved whether a particular instrument fell within the term "investment contract."[111] The Court stated that the test need not apply to all terms listed in the Acts' definition because using the test to define each specific term would make their listing needless.[112]

The majority also rejected the investor/entrepreneur distinction suggested by the respondents.[113] The Court based its position on the use of the term "security" in other sections of the 1934 Act.[114] Excepting entrepreneurial instruments from the definition of security would contradict the reasons behind these sections.[115] Moreover, although the 1933 Act exempts private transactions, such as entrepreneurial dealings, from its registration requirements, entrepreneurial transactions are still subject to the 1933 Act's antifraud provisions.[116]

After disposing of the respondents' arguments, the Court discussed the Third Circuit's worry that establishing stock as a security by proving its characteristics would require treating other instruments listed in the definition of security, like notes, in an identical manner.[117] The Court declined to decide whether the approach used in this case applied to other specific instruments named in the statute because, in the Court's view, stock constituted a special situation.[118] First, most people picture stock as a security.[119]

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108. *Id.* at 2304, 85 L. Ed. 2d at 700.

109. *Id.*

110. *Id.* The Court cited passages from *Joiner*, 320 U.S. at 352-55, and *Forman*, 421 U.S. at 849-58, as support for this principle. The *Forman* court had called the *Joiner* language used here dictum. *Forman*, 421 U.S. at 850.

111. 105 S. Ct. at 2305, 85 L. Ed. 2d at 701.

112. *Id.* (citing Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982)). The Court explained that although it had equated investment contracts with instruments typically thought of as securities, it did not intend the *Howey* test to apply whenever a case allegedly involved a security. 105 S. Ct. at 2305 n.5, 85 L. Ed. 2d at 701 n.5.

113. *Id.* at 2305, 85 L. Ed. 2d at 701.

114. Securities Exchange Act of 1934, §§ 14, 16, 15 U.S.C. §§ 78n, 78p (1982). These sections regulate tender offers and disclosure of insider dealings.

115. 105 S. Ct. at 2305, 85 L. Ed. 2d at 701; *see* Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983); Schneider, *The Sale of a Business Doctrine—Another View*, 37 SW. L.J. 461, 485-86 (1983). *But see* Easley, *supra* note 10, at 965-66 (tender offer concerns do not require rejection of the doctrine).

116. 105 S. Ct. at 2305, 85 L. Ed. 2d at 701 (citing Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983)). *But see* Easley, *supra* note 10, at 956 (*Daily* court confused exception with exemption).

117. The appellate court failed to see how stock could be distinguished from other instruments. The Supreme Court found that stock deserved special treatment by its very nature, and courts did not have to rationalize the difference in treatment.

118. 105 S. Ct. at 2306, 85 L. Ed. 2d at 702.

The Court again returned to the idea that people probably expect protection when they purchase stock because it is the most common type of security.[120] Second, one can identify stock with comparative ease because it has the five particular characteristics.[121] A note, on the other hand, includes instruments that possess differing attributes.[122]

In Part IV of its opinion the Court discussed additional policy reasons against the sale of business doctrine.[123] The majority expressed grave concern over application of the doctrine hinging on whether the purchaser had assumed control.[124] A critical question in the Court's mind was whether control had passed in this case since the buyers had never intended to manage the company.[125] The Court noted that even proponents of the doctrine argue that a buyer who has the capability to exert control but chooses not to do so merits the Acts' protection.[126]

Of more import, that Court stated that approval of the sale of business doctrine would present complex issues of line drawing because the doctrine would apply to sales of less than one hundred percent of a company's shares.[127] Coverage would then depend on a variety of factors such as the number of buyers, voting and veto agreements, and the percentage of stock exchanged.[128] At the time of sale neither party would know whether the Acts applied.[129] This doubt would not serve either party's interest.[130]

Justice Stevens's dissent argued that Congress never intended the Acts to protect every transaction that included an instrument listed in one of the Acts' definitions.[131] The prefatory clause reinforced this interpretation.[132] The legislative history of the Acts demonstrated that Congress was concerned with securities exchanged in the public arena.[133] Congress desired to guard investors who did not possess the leverage to receive inside informa-

119. *Id.*; *see* Daily v. Morgan, 701 F.2d 496, 500 (5th Cir. 1983); L. Loss, *supra* note 103, at 212.

120. 105 S. Ct. at 2302, 85 L. Ed. 2d at 697.

121. *Id.* at 2302, 85 L. Ed. 2d at 697-98.

122. *Id.* at 2306, 85 L. Ed. 2d at 702.

123. The majority had already mentioned one policy concern three times. *Id.* at 2302, 85 L. Ed. 2d at 697-98.

124. *Id.* at 2307, 85 L. Ed. 2d at 703-04; *see* Golden v. Garafalo, 678 F.2d 1139, 1146 (1982). *But see id.* at 1149 (Lumbard, J., dissenting) (majority's concerns not based on the facts of other cases).

125. 105 S. Ct. at 2307, 85 L. Ed. 2d at 703. This clearly contradicted the appellate court's finding. 731 F.2d at 1353.

126. 105 S. Ct. at 2307, 85 L. Ed. 2d at 703-04 (citing Easley, *supra* note 10, at 971-72); *see* Seldin, *supra* note 53, at 679. Whether the tenor of these articles reflects the Court's interpretation of them remains open to question.

127. 105 S. Ct. at 2307, 85 L. Ed. 2d at 704. *But see* Easley, *supra* note 10, at 958 n.226 (courts often draw more difficult distinctions); Seldin, *supra* note 53, at 678 (same).

128. 105 S. Ct. at 2307, 85 L. Ed. 2d at 704.

129. *Id.*; *see* Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983); Golden v. Garafalo, 678 F.2d 1139, 1146 (1982). *But see id.* at 1149-50 (Lumbard, J., dissenting) (contractual protections may prevent uncertainty).

130. 105 S. Ct. at 2307, 85 L. Ed. 2d at 704.

131. *Id.* at 2312, 85 L. Ed. 2d at 705.

132. *Id.*; *see* Marine Bank v. Weaver, 455 U.S. 551, 556 (1982); Tcherepnin v. Knight, 389 U.S. 332, 335 (1967).

133. 105 S. Ct. at 2312, 85 L. Ed. 2d at 704.

tion or the ability to protect themselves with contractual provisions.[134] Justice Stevens further argued that no distinction should exist between an analysis of stock and notes[135] because parties to a sale of a business may use a sale of stock for reasons unrelated to the federal securities law policy of protecting investors.[136] Justice Stevens acknowledged that some doubt about the Acts' scope would result from his dissent, but he felt that the harm of extending the Acts' protection beyond Congress's initial concern outweighed the majority's concern that investors be assured of protection in all cases.[137]

IV. CONCLUSION

As a result of *Landreth* the Acts cover the sale of stock, even if a transfer of control results from the sale, so long as the transferred stock has the usual characteristics of stock. To remain outside the control of the Acts, the parties must structure the sale of a business as a sale of assets and not stock. Throughout the opinion the Court emphasized that most people consider stock as a security. This repeated concern demonstrates that this policy consideration provided the primary basis for the Court's interpretation of the definition of security. Whether specifically labeled instruments other than stock, such as notes and bonds, can constitute securities under the *Landreth* approach remains unclear.

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134. *Id.*

135. *Id.* at 2313, 85 L. Ed. 2d at 705; *see* Seldin, *supra* note 53, at 669-70.

136. 105 S. Ct. at 2313, 85 L. Ed. 2d at 706. These reasons include tax obligations, assignability of instruments, and the apportionment of liabilities.

137. *Id.* (citing Sutter v. Groen, 687 F.2d 197, 202 (7th Cir. 1982)). The majority argued that the uncertainty of the Acts' coverage outweighed any other considerations. 105 S. Ct. at 2307, 85 L. Ed. 2d at 704. *But see* Easley, *supra* note 10, at 946-65 (parties can create certainty with contractual provisions).