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THE SALE OF A BUSINESS DOCTRINE—
ANOTHER VIEW

by

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tangible characteristics provide insight into the artificiality of the analytical model called the "sale of a business" doctrine. The question of whether the purchase or sale of all or substantially all interest in a business entity creates less risk than the purchase or sale of a lesser interest, is an open question beyond the scope of this Article. This Article examines the sale of a business doctrine, which states that the transfer of a business accomplished by means of the transfer of its stock does not result in the purchase or sale of a security. Thus, none of the regulations of the Federal Securities Acts would apply to the transaction. To date, six federal appellate courts have considered this question. Three courts of appeals have adopted the doctrine and three have denied it. Numerous district courts in other circuits have also faced the issue.

Analysis of the sale of a business doctrine begins with the eight United States Supreme Court cases that have interpreted the statutory definitions of a security. Those cases are sufficiently ambiguous to support either of the circuit courts' positions, as a closer look at five of the appellate court cases will demonstrate. Finally, this Article considers some of the unforeseen implications of the adoption of the sale of a business doctrine.

I. A Security Defined: The Supreme Court Decisions

The Supreme Court since 1943 has granted petitions for certiorari in eight cases involving the issue of whether the particular interest at stake qualified as a security. Of the nine interests involved, five were found to

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be securities and four were not. In each case decided between 1943 and 1967 the interest was found to be a security protected by the Federal Securities Acts. All four interests involved in cases decided between 1975 and 1982 were found not to be securities, and protection under federal law was denied. A consistent thread of reasoning runs through all eight cases, however, so that a purely chronological policy-shift explanation is inadequate. Rather, the decisions must be examined in terms of the statutory language involved and the policy rationales that underlie the federal regulatory regime.

The statutory definitions of a security in the Securities Act and the Securities Exchange Act are virtually identical, and the Court has cited


16. The decisions of the Supreme Court in securities cases began their present conservative direction in 1975. The three security definition cases in this period were all consistent with that conservative movement, although they retain a basic central consistency with their five predecessors. Both SEC v. W.J. Howey Co. and SEC v. C.M. Joiner Leasing Corp. provided the principles for that consistency. See infra notes 22-37 and accompanying text.

The issue in the sale of a business doctrine case creates a more difficult problem for the Court than the issue in the three cases in which certiorari was granted. The adoption of the analysis mandated by the doctrine would be consistent with the general conservative direction of the Court and some of the dicta in earlier cases, but not with the narrow holding of United Hous. Found., Inc. v. Forman. See infra notes 88-107 and accompanying text.

17. 15 U.S.C. § 77b (1976) states:

When used in this subchapter unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, 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, 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. 15 U.S.C. § 78c(a) (1976) provides:

When used in this chapter, unless the context otherwise requires—

(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 certifi-
the cases interpreting them interchangeably. Each definition begins with the phrase "unless the context otherwise requires" and proceeds to list a series of instruments commonly recognized as securities. Three important catchall categories extend the reach of the Acts to cover an interest in any profit-sharing agreement, any investment contract, and any interest commonly regarded as a security. The interests involved in the eight Supreme Court cases can be viewed analytically in three categories. The first group includes interests that answer to a nonsecurities name and have a nonsecurities appearance. A second class includes interests that answer to a nonsecurities name, but have some surface characteristics that resemble securities. The third category embraces interests that have a securities name and surface characteristics that resemble a security.

The Supreme Court has developed two similar but distinct tests for interests in the first category. In SEC v. C.M. Joiner Leasing Corp. the Securities and Exchange Commission sued to enjoin unregistered mail offers of subleases on very small parcels of Texas oil land. Both the district court and the circuit court found the interests to be oil and gas leases and not securities. The language of the Securities Act specifically included only fractional undivided interests in mineral rights; thus, the interest could be a security only if it was covered by one of the catchall categories. The Supreme Court held the interest to be an investment contract, using state blue sky law history as an analytical vehicle. The Supreme Court also established the first federal test for an investment contract, which inquired into "[the] character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." Since the leases in Joiner had been widely distributed by mail offers that included promises of exploratory wells nearby, they were unlike pure real estate leases and their character in commerce resembled an interest in a development project. The test stated and applied by the Court in Joiner could be characterized as a view through

cate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, 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.

21. Id. §§ 77b(1), 78c(a)(10).
22. 320 U.S. 344 (1943).
25. 320 U.S. at 352 n.10.
26. Id. at 353. The Court stated that the offerings were not beyond the scope of federal securities regulation even though the interest conveyed was an interest in real estate under Texas law. Id.
27. Id. at 352-53.
the eyes of the promoter, dependent upon the distribution scheme devised and the terms and inducements offered.

In *SEC v. W.J. Howey Co.* the Commission sought to enjoin the unregistered offer and sale of small fee-simple interests in land evidenced by a warranty deed and accompanied by an optional service contract to harvest and sell the citrus fruit growing on the land. The district court viewed the transactions as ordinary real estate sales with an optional management contract available. The Supreme Court decision in *Howey* did not apply the *Joiner* test, but rather established a new test that changed the emphasis from the commercial character of the instrument in commerce to the now famous “economic reality” language. While the character of the instrument in commerce might be objectively judged by the totality of the promoter's activities, the economic reality of the instrument is judged by the more subjective economic influences on the investor. Those economic influences that traditionally had defined an investment contract became the core of the new test. The Supreme Court held that “an investment contract for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . .” As a matter of economic reality, the profitability of investments in very small parcels of citrus grove land would depend upon the joint harvesting and marketing efforts under the service contract provided by the promoters.

In *Joiner* and *Howey* the Court, when required to analyze two interests

30. 328 U.S. at 299. It is not at all clear that the application of the *Joiner* test would result in finding a security in the *Howey* set of facts. The *Howey* opinion states that the consideration of economic risk-taking and profit-seeking underlies the *Joiner* decision. Id. at 299. Certain key elements, however, would have proven troublesome. First, the “character the instrument is given in commerce” would look very much like a sale of real property with a warranty deed. The distribution plan was unlike *Joiner* because most of the parcels were sold to buyers who were physically present to view the orchard while visiting an adjacent resort. The offer's terms did not compel a conclusion that the transaction would not be characterized as a sale of a real property interest in agricultural land. The economic incentives offered the purchaser would be the only part of the test that could make the real property interest look weak.
31. The *Joiner* decision seems weighted towards the distribution scheme and acts of the promoters. Arguably there were additional underlying factors. The portion of the test described as “economic inducements held out to the prospect” is vague. 320 U.S. at 353. In the context of *Joiner* the small subleases were valueless without drilling and they were too small to justify drilling by the sublessee. This was not necessarily true of the fee simple interests in portions of the orchard in *Howey*. A stronger justification for the similarity in underlying purpose of the two cases would be *Joiner*’s reference to other decisions that raise the dominant issue of *Howey*, the investor's reliance upon the efforts of others for his reward. 320 U.S. at 352 n.10. *Joiner* ignores that factor unless this principle is subsumed in the “economic inducement held out to the prospect.”
32. *Howey*, 328 U.S. at 298.
33. The decision in *Howey*, like *Joiner*, turns to state blue sky law cases as a source for defining an investment contract. See *Howey*, 328 U.S. at 298 n.4.
34. Id. at 299.
that on the surface did not resemble securities, devised two tests to determine whether the interests could be classified as statutory securities in the investment contract category. The Joiner test emphasized the appearance of the interest in commerce as judged by the distributional scheme.\textsuperscript{35} The Howey test emphasized the nature of the purchaser's expectations.\textsuperscript{36} The Court did not clearly indicate whether these were different tests, or if they were, whether they were alternative tests, or whether the second superseded the first.

In the five cases following Joiner and Howey the Supreme Court analyzed interests facially resembling a security and placed a heavy emphasis on the Howey test, with only one reference to the Joiner test.\textsuperscript{37} When the Supreme Court again examined an interest bearing no facial resemblance to a security, however, it utilized the Joiner test. In \textit{Marine Bank v. Weaver} the plaintiff guaranteed a loan made by the defendant to a third party. The transaction included a pledge of a certificate of deposit, purchased by the plaintiff from the defendant bank, to collateralize the loan, and an agreement between the plaintiff-guarantor and the third-party debtor providing contractual benefits to the plaintiff. The plaintiff sued to void the guarantee, alleging it was part of a transaction that violated rule 10b-5.\textsuperscript{39} The Third Circuit Court of Appeals reversed the district court's summary judgment for the defendant and concluded that a jury could have found either the certificate of deposit or the agreement to be a security.\textsuperscript{40} Since the agreement did not facially resemble a security, the Court's analysis of it is considered at this point.\textsuperscript{41}

The agreement provided the plaintiff with four promises as consideration for his guarantee of the bank's loan to the promisor. The plaintiff was to receive $100 per month, fifty percent of the net profits of the promisor's company, the use of the promisor's barn and pasture, and the right to veto future borrowing by the promisor. The circuit court applied the Howey test and found an investment of money in a common enterprise with profits to come solely from the efforts of others.\textsuperscript{42} The Supreme Court unanimously disagreed, not with the application of the test, but with the choice of tests. In Joiner and Howey the interests, which did not resemble but were found to be securities, were offered to a number of potential inves-

\textsuperscript{35} 320 U.S. at 352-53.
\textsuperscript{36} 328 U.S. at 298-99.
\textsuperscript{38} 455 U.S. 551 (1982).
\textsuperscript{39} 17 C.F.R. § 240.10b-5 (1982).
\textsuperscript{41} The court's treatment of the certificate of deposit, which did bear a facial resemblance to a security, is discussed \textit{infra} at notes 109-12 and accompanying text.
\textsuperscript{42} 637 F.2d at 162.
tors and could have been traded publicly because they offered equivalent value to many people. The unique privately tailored agreement involved in *Marine Bank* failed the *Joiner* test, which is based on the commercial character of the instrument, and thus was not a statutory security. The number of potential investors and the lack of a distribution scheme, or at least the inapplicability of one, are also important criteria. The tentative conclusion emerging from *Joiner, Howey,* and *Marine Bank* holds that interests that do not at least facially resemble securities should be examined as to distributional scheme, objective commercial character, and subjective investment characteristics. Evidently only those interests that meet both tests would be classified as investment contracts and thereby as statutory securities.

The second category of interests represented in the Court's analysis of the statutory security definition differ from the first category by bearing some facial resemblance to a security. The Court has analyzed such interests in three cases. In *SEC v. Variable Annuity Life Insurance Co. (VALIC)* the Securities and Exchange Commission (SEC) sued to enjoin the unregistered sale of a newly devised interest, a variable annuity, intended to protect against inflationary risks. A traditional annuity is a contract between the annuitant and an insurance company. The contract requires the annuitant to pay the insurer a fixed amount of money in either a lump sum or installments. Once he reaches the contractual age the annuitant receives a fixed periodic benefit for the balance of the annuitant's life. Thus the benefit to be received is a product of the expected yield on the funds paid to the insurer and the actuarial life expectancy of the annuitant beyond the contractual age at which benefits begin. In an inflationary economy annuities have become less desirable because the fixed benefits are paid in funds whose purchasing power had declined. The variable annuity was designed to protect the annuitant against inflation. During the pay-in period the annuitant purchases annuity units whose value will fluctuate with the value of the investment of those funds by the insurer. At the end of the pay-in period, the amount of the future benefits is determined based upon the value of the funds paid in as invested (instead of the amount actually paid in) and the actuarial life expectancy of the annuitant.

Justice Douglas's opinion for the Court in *VALIC* fixed the incidence of the risk-bearing feature of the contract as a decisive starting point for anal-

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43. 455 U.S. at 559.
44. *Id.* at 560.
45. *Id.; see Joiner,* 320 U.S. at 352-53.
47. *See Howey,* 328 U.S. at 298.
ysis.\textsuperscript{51} If the risk as to the amount of the ultimate benefits (other than the actuarial risk) had been on the insurer, the opinion implies that the annuity would not have been a security.\textsuperscript{52} Since the annuitant bore the substantial risk, however, that risk being the value of a pro rata share of the equity interests in the portfolio, the interest was held to be a security.\textsuperscript{53} The value of the annuity ultimately depended on the value of an investment of money by the annuitant in a common enterprise, with profits expected solely from the efforts of others.\textsuperscript{54} Thus, the Supreme Court resolved the first case involving an interest with a facial resemblance to a security by using the \textit{Howey} test to determine the investment contract character of the interest.

Justice Douglas's opinion in \textit{VALIC} is cryptic due to the intermingling of several issues in the case. The Court could have first determined whether the interest was a security. If the answer were no, the case would have been resolved. If the answer were yes, the issue of the security's exemption from registration under Securities Act section 3(a)(8)\textsuperscript{55} would need to be resolved. The resolution of this issue would be totally separate from the first issue and its analysis appropriately different. The Court clouded its rationale by intermingling the two issues.

While Justice Douglas did respond to the dual issues of the existence of a security and exemption from the regulatory scheme, Justice Brennan's concurrence emphasized policy considerations.\textsuperscript{56} Under the Securities Act the emphasis is on disclosure of the details of the enterprise.\textsuperscript{57} State insurance acts emphasize the solvency and adequacy of the reserves of the insurance company.\textsuperscript{58} Because the obligation of the insurer under a variable annuity is based primarily on the value of the investment of the paid-in funds, traditional types of insurance regulation controlling the risk of insolvency are meaningless. Disclosure to the investor of the planned use of funds and the character of the enterprise is clearly more valuable, but is mandated only if the interest is deemed a statutory security. Justice Brennan concluded that the choice of applicable laws depended on which regulatory scheme afforded adequate protection for the interest at stake.\textsuperscript{59} In this case the federal securities law provided the greater protection.

The insurance industry reacted to the decision in \textit{VALIC} by devising a variation to the variable annuity called a flexible fund annuity. The flex-

\begin{itemize}
\item \textsuperscript{51} See 359 U.S. at 71. Though strains of Justice Traynor's subsequent risk capital theory are implied by the emphasis on where the risk lies, the total context of the opinion uses this issue to identify a starting point rather than a basic analytical tool. See Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The California Supreme Court held a membership in a country club to be a security because risk capital was solicited in order to develop a profitable business. 361 P.2d at 908, 13 Cal. Rptr. at 188.
\item \textsuperscript{52} See 359 U.S. at 71-73.
\item \textsuperscript{53} \textit{Id.} at 71.
\item \textsuperscript{54} \textit{Id.} at 72 n.13 (quoting \textit{Howey}, 328 U.S. at 298-99).
\item \textsuperscript{55} 15 U.S.C. § 77c(a)(8) (1976).
\item \textsuperscript{56} 359 U.S. at 80 (Brennan, J., concurring).
\item \textsuperscript{57} \textit{Id.} at 85.
\item \textsuperscript{58} \textit{Id.}
\item \textsuperscript{59} \textit{Id.} at 85-86.
\end{itemize}
ible fund annuity gave the annuitant the option of converting paid-in
funds to an annuity as with the variable annuity or converting the paid-in
funds to an annuity based upon a predetermined cash value. In theory,
this option placed the risk that concerned Justice Douglas in VALIC upon
the insurer, but still provided the annuitant the potential of an enhanced
value due to any appreciation in the fund. In SEC v. United Benefit Life
Insurance Co. the SEC sought to enjoin the unregistered distribution of
these interests, arguing that they too were statutory securities. The
Supreme Court could have resolved the issue quite easily. The option of
receiving the predetermined cash value, called the flexible fund guarantee,
that would have placed substantial risk on the insurer, was illusory. The
guarantee amounted to less than the paid-in funds and thus caused the
annuitant to bear the greatest portion of the risk. This new scheme was
substantially indistinguishable from the VALIC scheme, and application
of the Howey test would have provided an adequate resolution. Justice
Harlan's majority opinion, however, chose instead to analyze the annuity's
investment contract characteristics by applying the Joiner test. The appli-
cation of this test changed the focus of the analysis to the commercial char-
acter of the instrument from the offeror's perspective. The Court found
that such schemes "offer important competition to mutual funds . . . and
are pitched to the same consumer interest in growth through professionally
managed investment." Thus, the manner in which the interest was
"pitched" or distributed could positively affect its character as a security.

Not until 1979 did the Court again analyze an interest having some fa-
cial resemblance to a traditional security. In International Brotherhood of
Teamsters v. Daniel the plaintiff contended that his noncontributory (em-
ployer-contributed) interest in a pension fund was a security and alleged a
violation of rule 10b-5 caused by a lack of disclosure of material facts
concerning the vesting of the interest. Both the district court and the cir-
cuit court applied the Howey test to the interest. The lower courts found
a common enterprise and profits derived from the management of the fund
by others, but had difficulty finding the required investment of money.
The Supreme Court resolved the difficulty by viewing the employer's con-
tribution to the fund as part of the total compensation package paid as
consideration for the plaintiff's labor. The employer's contribution was
functionally equivalent to payment of the employee and investment by the
employee of a portion of his compensation in the fund. The Court found,
however, that the plaintiff had sold his labor, not made an investment, and
thus lacked the requisite expectation of profits derived from the efforts of

60. 387 U.S. 202 (1967).
61. Id. at 208 n.10.
62. Id. at 211 (citing Joiner, 320 U.S. at 352-53).
63. 387 U.S. at 211.
64. 439 U.S. 551 (1979).
67. 439 U.S. at 559-61.
others. The Court held that the interest was not a security. 68

Use of the Joiner test in addition to the Howey test would have made a resolution of the issue consistent with that reached easier. Joiner’s focus on the character of the interest in commerce as determined by the means of distribution or the way in which the interest was “pitched” would clearly take it out of the security category. The interest in Daniel bore no resemblance to a security because it was distributed to every member of the union irrespective of desire and was offered to the union as a whole rather than to an individual recipient. Justice Powell’s majority opinion bypassed the Joiner test, however, and emphasized the importance of the Howey test, as relied on in United Housing Foundation, Inc. v. Forman 69 four years previously. “In Forman . . . we observed that the Howey test, which has been used to determine the presence of an investment contract, embodies the essential attributes that run through all of the Court’s decisions defining a security.” 70 The Court’s approach in Daniel forced a questionably narrow application of the Howey test 71 and substantially undercut the viability of the Joiner test, at least with respect to interests that facially resemble securities.

The Daniel Court also relied on the policy approach taken by Justice Brennan in his VALIC concurrence to conclude that the pension fund interest was not a security. The competing regulatory schemes involved in Daniel were the disclosures mandated by the Securities Acts and the specific disclosure and regulation provisions for pension funds under the Employee Retirement Income Security Act (ERISA). 72 The ERISA disclosure 73 and regulation 74 provisions provide protection for persons

68. Id. at 560, 562.


70. 439 U.S. at 558. The Howey test focuses on the economic realities surrounding the transaction. Justice Powell noted that the Court in Forman observed that this test “‘run[s] through all the Court’s decisions defining a security.’” Id. at 558 n.11 (quoting Forman, 421 U.S. at 852).

71. See 439 U.S. at 558-62. Instead of recognizing the voluntary aspect of an investment decision, the opinion artificially suggested that the important term in “investment of money” is the word “money.” Therefore, the absence of some tangible consideration becomes significant. Id. at 560. The opinion immediately retreated from this position, however, noting that an investment contract may be found not only when the consideration is cash, but also when the investment is in the form of goods or services. Id. at 560 n.12. The Court then looked at the economic realities of the services rendered as consideration for the total compensation package to determine if an investment was made. Id. at 560. The Court concluded that the “employee is selling his labor primarily to obtain a livelihood, not making an investment.” Id. Finally, the Court’s application of the Howey requirement of the expectation of profits from a common enterprise managed by someone other than the investor is even more questionable. The opinion suggested that because the greatest part of the benefits come from the employer contributions to the plan, rather than from the earnings of the trustee-managed fund, this requirement of Howey was absent. Id. at 561-62. The artificiality of this reasoning calls into question whether the interest in a mutual fund is a security and is inconsistent with the prior analysis that suggests that the employer’s contribution is insignificant.


such as the plaintiff and thus militate against finding the interest involved to be a security.\textsuperscript{75}

The third category of interests, which bear both a securities name and a facial resemblance to a security, is represented in three cases.\textsuperscript{76} \textit{Tcherepnin v. Knight}\textsuperscript{77} concerned an interest established by state statute in a state savings and loan association. The Court described the interests as “withdrawable capital shares.”\textsuperscript{78} The name of the instrument was a hybrid, with “share” sounding like a security and “withdrawable” like a savings account. Although the name given the interest is not conclusive, in \textit{Joiner} the Court noted that some interests “such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning.”\textsuperscript{79} The interests involved in \textit{Tcherepnin}, however, were not specifically included in the statutory definition of a security, to which by implication deference would be paid.\textsuperscript{80}

Justice Warren’s opinion for the Court emphasized the fact that the interests involved were created by state statutes.\textsuperscript{81} Instead of considering the character of the instrument in commerce\textsuperscript{82} or the economic reality of the interest,\textsuperscript{83} the Court focused on “the legal character imparted to those shares by the statute.”\textsuperscript{84} The important statutory characteristics noted in the opinion were (1) voting rights apportioned by value, (2) dividends declared by the board of directors out of profits rather than measured by a fixed rate of return, (3) restrictions on voluntary withdrawals, and (4) limited negotiability.\textsuperscript{85} The next step in the Court’s analysis injected considerable ambiguity into the opinion. The Court did not immediately decide whether these legal characteristics made the interests statutory securities. Rather, the Court returned to the \textit{Howey} test and found that the interests had the essential attributes of an investment contract.\textsuperscript{86} The Court then continued beyond the \textit{Howey} test and held that the legal characteristics of the interests also qualified them as “certificate[s] of interest or participation in any profit-sharing agreement,” “stock,” and “transferable shares,” all of which are specifically included in the statutory definition of a security.\textsuperscript{87}

\begin{footnotesize}
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\item[75.] 439 U.S. at 569-70.
\item[77.] 389 U.S. 332 (1967).
\item[78.] Id. at 333.
\item[79.] 320 U.S. at 351.
\item[80.] See 389 U.S. at 338. The \textit{Joiner} Court added that “[i]nstruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description.” 320 U.S. at 351.
\item[81.] Id. at 336-39.
\item[82.] \textit{Joiner}, 320 U.S. at 352-53.
\item[83.] \textit{Howey}, 328 U.S. at 298.
\item[84.] 389 U.S. at 336.
\item[85.] Id. at 337.
\item[86.] Id. at 338.
\item[87.] Id. at 339-40; 15 U.S.C. § 78c(a)(10) (1976).
\end{enumerate}
\end{footnotesize}
The Court's ambivalence left unclear the appropriate mode of analysis for interests bearing a strong facial resemblance to a security.

*United Housing Foundation, Inc. v. Forman* provided the Court with an opportunity to dispel the ambiguity in *Tcherepnin*. The plaintiffs had purchased shares of common stock in a nonprofit corporation, created by state statute, that entitled them to rent a low-cost apartment in a privately owned state-subsidized housing project. The appellate court held the interest a security upon two alternative grounds.89 First, the shares in the housing project were denominated as stock, bringing them within the literal language of the Securities Acts.90 Second, the court of appeals held that the interest satisfied the *Howey* economic reality test and was thus an investment contract.91

The Supreme Court reversed, holding that the interest was not a security under either analysis.92 The denomination of the interest as stock was not decisive, according to the Court.93 The statute provides that "the term "security" means any . . . stock,"94 but these words are preceded by the phrase "unless the context otherwise requires."95 The language of the statute thus requires consideration of the circumstances surrounding the transaction even when the interest resembles a security so strongly that its name tracks the statutory language. This holding substantially weakens the *Joiner/Tcherepnin* dicta requiring deference to the name of the interest.96 As the Court began its consideration of the circumstances surrounding the transaction, three models were available to it: *Joiner*'s "character in commerce,"97 *Howey*'s "economic reality,"98 and *Tcherepnin*'s legal characteristics.99 The Court decisively chose *Howey* as setting forth the proper approach.100 Justice Powell's opinion stated that it is the economic realities underlying a transaction that are critical.101 This statement is misleading because the Court applied the economic realities test to the interest involved to determine if those realities were consistent with the name given to the interest.102 Finding them inconsistent, the majority concluded that

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90. Id. at 1252.
91. Id. at 1255.
92. 421 U.S. at 859-60.
93. Id. at 848.
95. Id. §§ 77b, 78c(a).
97. 320 U.S. at 352.
98. 328 U.S. at 298.
99. 389 U.S. at 339.
100. 421 U.S. at 859.
101. Id. at 851:
102. Id. at 851:

These shares have none of the characteristics "that in our commercial world fall within the ordinary concept of a security" H.R. Rep. No. 85, [73d Cong., 1st Sess.] 11 [(1933)]. Despite their name, they lack what the Court in *Tcherepnin* deemed the most common feature of stock: the right to receive "dividends contingent upon an apportionment of profits." 389 U.S., at 339. Nor do
merely labelling an interest "stock" does not place the interest within the statutory definition.\textsuperscript{103}

The Court turned next to the alternative holding of the appellate court, which had held the interest to be an investment contract.\textsuperscript{104} The Court again used the \textit{Howey} test for an investment contract, but here the Court considered the economic reality of the transaction.\textsuperscript{105} The \textit{Howey} tripartite test as restated by the Court describes the economic realities of an investment contract transaction as "an investment of money in a common enterprise with the profits to come solely from the efforts of others."\textsuperscript{106} The Court found that the purchasers in \textit{Forman} were interested in acquiring low-cost housing rather than making a profitable investment.\textsuperscript{107} The interest thus was not an investment contract.\textsuperscript{108}

The Supreme Court most recently analyzed an interest that facially resembled a security in \textit{Marine Bank v. Weaver}.\textsuperscript{109} The certificate of deposit purchased and pledged in \textit{Marine Bank} arguably resembled other long-term debt obligations. A parallel to the \textit{Forman} mode of analysis can be found in the language of the opinion. Under the Securities Exchange Act, the definition of a security most similar to a certificate of deposit was that which covers any note having a maturity exceeding nine months.\textsuperscript{110} The \textit{Forman} approach then required an analysis of the economic reality of the transaction or interest. In \textit{Marine Bank} the certificate of deposit received a fixed rate of return commensurate with the risk of the investment. The risk of loss was virtually nonexistent because of the protection afforded by the

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  \item[103.] \textit{Id.} at 858. This raises two very significant issues for the analysis of the "sale of a business" doctrine. First, if the business enterprise is transferred by means of the sale of its stock, what happens to the \textit{Joiner/Tcherepnin} deference? It continues to exist if the interest involved is consistent with its name. \textit{Forman} provided the economic reality test for the consistency. The second issue is economic reality of what? If it is the economic reality of the underlying transaction, as Justice Powell's opinion expressly stated, great difficulty is encountered. If it is the economic reality of the interest itself, as in Justice Powell's application, the interest will certainly be consistent with its name.
  \item[104.] 500 F.2d at 1255. This step would not have been required if the economic reality of the stock interest had been consistent with its name. It would have been a security regardless of whether or not it was an investment contract.
  \item[105.] 421 U.S. at 851-56.
  \item[106.] \textit{Id.} at 852 (quoting \textit{Howey}, 328 U.S. at 301).
  \item[107.] 421 U.S. at 860.
  \item[108.] Justice Powell's broad dictum in \textit{Forman} suggests an alternative policy argument extending beyond the narrow issues before the Court, which provides support for the sale of a business doctrine adopted by the Seventh Circuit Court of Appeals in \textit{Canfield v. Rapp & Son, Inc.}, 654 F.2d 459 (7th Cir. 1981). After reviewing the congressional policy underlying the Securities Act, Justice Powell described the implementation of this policy, stating that "[t]he task of [defining securities] has fallen . . . ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of those statutes." 421 U.S. at 848. This statement suggests that those transactions not covered by the policy underlying the Acts are not securities.
  \item[109.] 455 U.S. 551 (1982); see supra notes 38-41 and accompanying text.
\end{itemize}
\end{footnotesize}
Federal Deposit Insurance Corporation. Thus the true economic nature of the instrument made it unlike its statutory counterpart and no further analysis was required.

A surface reading of these Supreme Court cases supports a narrow technical argument concerning the proper approach to definition of a statutory security. If the instrument in question does not resemble a traditional security, Joiner requires examination of its commercial character and the distributional scheme. Howey requires analysis of the incentives that motivated the investment decision. Marine Bank appears to require satisfaction of both tests. If the instrument in question bears a slight facial resemblance to a traditional security, VALIC and Daniel indicate that the Howey test is sufficient and that United Benefit Life's reliance upon the Joiner test is unnecessary. Finally, if the instrument in question bears a strong facial resemblance to a traditional or statutorily defined security, the Forman test is appropriate. The Forman approach examines the underlying economic similarity between the interest and its statutory counterpart. The Howey test would be applied only when the instrument allegedly fell into the catch-all investment contract category.

Beneath the surface of these technical decisions lie the dicta of VALIC, Daniel, and Forman, which suggest a different approach to the definition of a security. Justice Brennan's concurrence in VALIC and the Court's opinion in Daniel imply that where an alternate regulatory scheme provides adequate investor protection, the need for similar protection under federal securities laws is greatly diminished. The Forman opinion suggests that the Howey tripartite test defines the category of investors Congress intended to protect. Viewed from this perspective, the Supreme Court decisions carry quite different implications. Within this somewhat ambiguous framework the courts of appeals have begun to develop models for the analysis of the sale of a business accomplished by the sale of equity interests.

111. 455 U.S. at 558-59.
112. Id.
113. See Joiner, 320 U.S. at 352.
114. See Howey, 328 U.S. at 298-99. The tripartite test is the investment of money, in a common enterprise, with the expectation of profits solely from the efforts of others. Id. at 301.
115. See supra notes 38-45, 109-12 and accompanying text (discussion of both tests as applied in Marine Bank).
116. See supra notes 51-54 and accompanying text (discussion of VALIC and Howey test); supra notes 66-71 and accompanying text (discussion of Daniel and Howey test).
117. See supra notes 62-63 and accompanying text.
118. See Forman, 421 U.S. at 850-51.
119. See id. at 851-53. Whenever the instrument no longer resembled a specific statutory counterpart, it would move back one category and the appropriate test for that category would be applied.
120. See supra notes 56-59, 72-75 and accompanying text.
121. See supra note 108.
II. An Emerging Doctrine: The Appellate Court Decisions

The Supreme Court decision in *United Housing Foundation, Inc. v. Forman*\(^{122}\) was critical of the formation of the sale of a business doctrine because it established that an instrument bearing a securities name need not automatically be considered a security. Thus, the important appellate court decisions are those with post-*Forman* analyses. The issue of treatment of the sale of a business under the securities laws first arose before the Tenth Circuit Court of Appeals in *Chandler v. Kew, Inc.*\(^{123}\) The summary fashion in which the issue was resolved indicated that its implications were not clear. The plaintiff in *Chandler* had acquired a liquor store by purchasing 100% of the stock from its owners. The court of appeals held the federal securities laws inapplicable.\(^{124}\) The court excerpted a quotation from *Forman* stating that Congress intended the application of the Securities Acts to turn on the economic realities underlying the transaction.\(^{125}\) The *Chandler* court characterized the economic realities of the case as the purchase of a liquor store and the incidental receipt of 100% of the stock as evidence of ownership.\(^{126}\) The court found "no security transaction within the purview of the federal statutes."\(^{127}\)

The *Chandler* opinion is extremely ambiguous. Alternative explanations may be given for the decision, but each creates analytical problems. One reading of the opinion suggests that the transaction did not come within the purview of the securities laws because the interest sold was not a security. The *Chandler* court did not make such a statement. This interpretation requires the conclusion that stock is not a security when it is only an incidental indicia of ownership. Unfortunately, stock in a corporation is never more than an indicia of ownership. A narrower reading of the opinion implies that stock is an incidental indicia of ownership only when 100% of it is purchased. This reasoning would change the outcome in every securities case resulting from a merger in which 100% of the stock of a corporation was acquired. Finally, the opinion may be read literally, with no implication as to the existence or nonexistence of a security.\(^{128}\) The opinion itself provides no guidance for characterizing the interests involved. Perhaps such an early decision should not be criticized for failing to anticipate the implications of a new idea.

When a seemingly similar problem arose in the Seventh Circuit almost four years later, the implications should have been clearer.\(^{129}\) In *Frederik-

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\(^{122}\) 421 U.S. 837 (1975).

\(^{123}\) [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977).

\(^{124}\) *Id.* at 96,054.

\(^{125}\) *Id.*

\(^{126}\) *Id.*

\(^{127}\) *Id.*

\(^{128}\) The court characterized the transaction as the purchase of a liquor store and stated that it was not within the purview of the statute. *Id.*

\(^{129}\) In the interim the Fourth Circuit, in *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), had analyzed a distinguishable situation and reached the opposite result. See *infra* notes 149-53 and accompanying text.
the court of appeals, however, dealt with a fact situation inappropriate for an expanded analysis. In a complex transaction the plaintiff, Emerald City Corporation (ECC), purchased the assets of the defendant's corporation, North Shore Marina, Inc. (NSM). ECC purchased the assets of NSM for cash at a gross value. Before NSM distributed the cash to its sole stockholder, ECC wanted assurance that all debts of NSM had been paid. To gain this assurance, ECC needed to acquire control of NSM, whose only asset was the cash in escrow paid for the assets. ECC accomplished this goal by purchasing ten percent of the NSM shares for ten dollars and placing the balance of the shares in a voting trust controlled by ECC. Upon payment of all of NSM's debts the stock in the voting trust was to be redeemed, and NSM collapsed. The transaction thus essentially involved a purchase by the plaintiff of the physical assets of another corporation for cash, rather than an acquisition of NSM or a stock purchase. Subsequently, the plaintiff became dissatisfied with the transaction and sued for damages resulting from fraud in connection with this alleged security transaction. The case contained none of the difficult issues presented by the sale of a business doctrine. Instead of taking the straightforward approach seemingly dictated by the facts of the transaction, however, Judge Sprecher's opinion for the court assumed that the plaintiff had acquired North Shore Marina. The court thus analyzed the definitional issue and ultimately concluded that the transaction was not within the purview of the federal securities laws.

Since the plaintiff had not acquired NSM or its stock, the issue discussed in the opinion was not properly before the court. Nevertheless, Frederiksen indicates the analysis the Seventh Circuit Court of Appeals would apply to a case involving the sale of a business. The court relied upon the

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131. Judge Sprecher's description of the transaction is self-contradictory. Early in the opinion Judge Sprecher described the transaction by stating "Emerald City Corporation ('ECC') negotiated for, and then purchased, the assets and stock of North Shore Marina, Inc. ('NSM')." 637 F.2d at 1148. If one purchased the assets of a corporation for cash, it would be pointless to purchase the stock of the corporation's single shareholder for cash to own thereby the right to the cash paid for the assets. The only purchase of shares by the plaintiff was a nominal purchase for $10 as consideration for the defendant's placing his shares in a voting trust to insure the payment of all debts before redemption. Id. at 1149.
132. The only purchase of stock was the nominal purchase for $10 of an interest in NSM's cash. Even if this was a purchase of stock, no fraud was connected with it and no demonstration made that this transaction was the cause of any loss to the plaintiff. If the plaintiff had argued that placing the balance of the defendant's NSM stock in a voting trust controlled by the plaintiff, for the defendant's benefit, was the sale of a security, the same problems would have been presented for the plaintiff's theory. Finally, if the plaintiff had argued that the purchase of assets was a purchase of a security, the only theory available would have been that of an investment contract. The use of the Howey tripartite test would resolve this issue easily and without controversy. No security transaction would be found because the criteria are (1) an investment of money or tangible property (2) with an expectation of profit (3) solely from the efforts of others, and in this case ECC assumed management control.
133. 637 F.2d at 1149. Judge Sprecher stated that "[t]he critical legal issue in this case is whether the plaintiffs' acquisition of North Shore Marina involves a 'security' . . . ." Id.
134. Id. at 1151-52.
general policy inherent in *Forman* rather than *Forman*’s technical analysis and recognized that the purpose underlying the Securities Act is protection of capital market investors through a registration and disclosure scheme.\(^{135}\) The court therefore concluded that one test of a security asks whether the interest is being sold to raise capital.\(^{136}\) Application of this test would mean that the secondary purchase or sale of any stock was not the purchase or sale of a security. Such a result ignores the need for protection of organized or informal secondary markets, which are essential to the maintenance of the primary market that raises initial capital. The *Frederiksen* court also stated that the primary test for a security, according to *Forman*, requires analysis of the underlying economic reality of the interest being purchased or sold.\(^{137}\) The opinion characterized *Forman* as contrasting investments with purchases in which the desire is to “‘use or consume the item purchased.’”\(^{138}\) *Forman* dealt with a consumer’s purchase of an interest that entitled him to live in a low-rent apartment. The *Frederiksen* court used *Forman*’s approach and suggested that the plaintiff wished to use the assets of NSM commercially rather than invest in them.\(^{139}\) Although this approach may be helpful in dealing with temporary interests such as leases or notes, it has little relevance to a purchase of assets to be used permanently in a commercial venture. Finally, the court equated *Forman*’s economic reality analysis with *Howey*’s tripartite test.\(^{140}\) Although the economic reality of an investment contract can be measured by this test, application of it to conventional securities produces unexpected results. Under the *Howey* test the entrepreneur who establishes a corporation would not be investing his money. The shares of stock evidencing his interest would not be securities. If the entrepreneur sold a portion of his interest to a third person, he would not be selling a security, but the buyer would be buying a security. If the entrepreneur sold a controlling interest in his corporation, he might be selling a security, but the buyer might not be purchasing a security. *Howey*’s tripartite test was never intended to be, nor is it capable of being the exclusive test for a security.

The *Frederiksen* decision left uncertain the position of the Seventh Circuit regarding the sale of a business doctrine. That circuit soon had an opportunity to clarify its stance, however. *Canfield v. Rapp & Sons, Inc.*\(^{141}\) involved a transaction structured without ambiguity. The plaintiffs had purchased 100% of the stock in the Twigg Corporation from its three owners. Judge Sprecher again wrote for the court, and applied an analysis that

\(^{135}\) *Id.* at 1150.

\(^{136}\) *Id.* This idea seems to be generated by Judge Sprecher’s attempt to distinguish the Fourth Circuit’s opinion in *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir. 1979), which did not require such a distinction. *See infra* notes 149-53 and accompanying text for a discussion of *Coffin* and its rejection of the sale of a business doctrine.

\(^{137}\) 637 F.2d at 1151.

\(^{138}\) *Id.* at 1150 (quoting *Forman*, 421 U.S. at 853).

\(^{139}\) 637 F.2d at 1150.

\(^{140}\) *Id.* at 1152.

\(^{141}\) 654 F.2d 459 (7th Cir. 1981).
placed Frederiksen in context.\textsuperscript{142} The court of appeals combined three separate concepts and developed a model of protection based on the definition of a security. The first concept used by the court provides that the name given to an interest is not binding on the court.\textsuperscript{143} The second concept states that the economic realities underlying the transaction, not the interest, indicate whether a security is involved.\textsuperscript{144} The third notion holds that the Howey tripartite test defines economic reality.\textsuperscript{145} This idea stresses the third element of the Howey test, which requires profits to be derived from the efforts of others.\textsuperscript{146} Together these three concepts indicate, according to the court, that the federal securities laws protect the interests of those who invest their money in enterprises that they do not control.\textsuperscript{147} A corollary to this result would hold that the federal securities acts were not intended to protect an interest acquired by the expenditure of money that represents control of the enterprise. Unfortunately, this For-

\textsuperscript{142} Id. at 463, 465-66. Some of the language in Canfield could indicate that it was an expansion of the concept established in Frederiksen, but Judge Sprecher probably would not so characterize it. It is useful, however, to make a distinction between the two decisions because Frederiksen, without its dictum, can be harmonized with other decisions not adopting the sale of a business doctrine, while Canfield cannot. Frederiksen involved the sale of the physical assets of a corporation and the nominal sale of some stock for $10 to assure the payment of the corporation's debts. The sale of stock was incident to the sale of something else that was difficult to define as a security. The plaintiffs were not buying and the defendant was not selling the stock (or securities) of North Shore Marina. The purchase and sale were of the assets, or, as one might generally characterize it, the "entire business" of North Shore Marina. Thus, when Judge Sprecher characterized Frederiksen as raising the "question of whether alleged fraud regarding the sale of stock incident to sale of an entire business falls within the scope of the federal securities laws," Canfield, 654 F.2d at 463 (emphasis added), he accurately described the holding. In this case the "incident to" language is very clear and would indicate that the principle of Chandler v. Kew, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977), was consistent, even though the application was unclear. When a transaction results, however, in only the purchase of the shares of a corporation and enough are purchased, the result will always be the purchase of the business. No criteria are established to indicate when such share purchases are incidental to the purchase of the business. Canfield is an expansion of Frederiksen because the incidental to language appears to become irrelevant.

\textsuperscript{143} 654 F.2d at 463. This concept originated in cases in which the interest was described as something unlike a security, but which actually had characteristics of a security. See Howey, 328 U.S. at 298; Joiner, 320 U.S. at 351. The concept was retained in cases where the name was closer to a traditional security. See Tcherepnin v. Knight, 389 U.S. 332, 338-39 (1967); SEC v. Variable Annuity Life Ins. Co. (VALIC), 359 U.S. 65, 69 (1959). In all of these cases because the name differed from the list of statutory securities, the Howey tripartite test was used to determine whether they were investment contracts. The concept as it arose in Forman was different. There the interest was named with a statutory definitional name. The test for this kind of interest was not Howey's tripartite test, but rather whether the interest had the characteristics of its name. See Forman, 421 U.S. at 847-48.

\textsuperscript{144} 654 F.2d at 463; see Forman, 421 U.S. at 852. This problem is engendered by the ambiguous language of Justice Powell's opinion in Forman. In Canfield Judge Sprecher hedged by addressing both concepts. In the text of the opinion he defined economic reality of the transaction to mean the Howey tripartite test. 654 F.2d at 463. He suggested, however, that the economic realities of the interest are not those of stock when 100% control is purchased. The fundamental characteristics of right to vote and right to receive dividends are not meaningful tests when the purchaser is unlike an investor because he controls them.

\textsuperscript{145} Id. at 466 n.7.

\textsuperscript{146} Id.

\textsuperscript{147} See id. at 463-64.
man-based policy reasoning was used to answer the threshold question of whether the interest was a security. Such an approach removed the interest entirely from coverage by the federal securities laws. A different approach might have limited application of a particular protective device such as registration under the Securities Act or antifraud coverage under the Securities Exchange Act. These implications must be considered before the analysis can be evaluated.148

The Fourth Circuit Court of Appeals applied an analysis contrary to that of Canfield in Coffin v. Polishing Machines, Inc.149 The facts of Coffin arguably did not represent an appropriate occasion for a discussion of the sale of a business doctrine because the plaintiff had purchased only a one-half interest in the corporation. The court's analysis, however, is clear. The court applied Forman's technical analysis in a straightforward fashion, and ignored the policy dicta in Forman relied upon by the Seventh Circuit in Canfield.150 The court recognized that the name given the interest is not necessarily controlling. Rather, the issue is whether the interest has the "significant characteristics typically associated with the named instrument." According to the court, the substance of the transaction need not be analyzed if the interest does not satisfy this test.152 The court concluded that the Howey test should be applied only when the interest lacks the characteristics associated with its name and therefore is not easily recognized as a security in the capital market.153 The Coffin court thus clearly rejected the sale of a business doctrine.

In Golden v. Garafalo154 the Second Circuit Court of Appeals provided a direct counterargument to the Seventh Circuit's Canfield decision. The plaintiffs in Golden had purchased 100% of the common stock of a corporation engaged in the ticket brokering service from its sole owner. The new owners were to be the sole managers of the business. The court of appeals squarely faced the security issue and rejected the sale of a business doctrine.155 The court first analyzed the relevant Supreme Court decisions and concluded that they were not dispositive of the question; the court did, however, find support in Forman for its refusal to adopt the sale of a business doctrine.156 The court also found the Howey tripartite test inapplicable because that test covers only unique interests that do not resemble statutorily named securities.157

The Golden decision is valuable because it provides the first in-depth judicial criticism of the sale of a new business doctrine. The court based its criticism on the difficulty of applying the third element of the Howey
test, which requires profits to come from the efforts of others, to traditional equity interests.\textsuperscript{158} If the existence of an intent to manage is the dispositive factor, intractable questions concerning passive investors forced into management roles and quasi-passive investors employed in limited capacities by the enterprise will arise. If control is the key element, the wide range of interests which may constitute control in any given business organization will make the existence of that element extremely difficult for a trial court to determine. Both approaches assume that a distinction can be made between commercial and investment interests. In the context of the purchase of a business, however, both types of interest are always present, and an attempt to suggest the primacy of one over the other would be artificial and arbitrary. Such an attempt would rest the availability of protection under the federal securities laws on “uncertain and slippery factors.”\textsuperscript{159}

Only one other circuit court of appeals has considered the sale of a business doctrine. In \textit{King v. Winkler}\textsuperscript{160} the Eleventh Circuit approached the issue from a slightly different direction. The plaintiffs in \textit{King} had agreed to purchase the defendant’s business, which had been listed for sale with a broker. After this agreement was made, attorneys were brought in to structure the transaction. A rather complex sequence of events resulted. The plaintiffs purchased all the stock of one corporation; thereafter, that corporation purchased all the stock of a second corporation, leaving the plaintiffs in full control of both corporations. The plaintiffs later filed suit alleging violations of the Securities Acts. The court of appeals held that the sequence of events was not a security transaction controlled by either Act.\textsuperscript{161} The court admitted that under the \textit{Forman} analysis the stock interest was a security, but nevertheless used the \textit{Howey} test to determine whether the case involved a transaction “intended to be governed by the Federal Securities Acts.”\textsuperscript{162}

The court’s approach lacks a statutory basis. The transactional exemptions from registration in the Securities Act do not depend on the \textit{Howey} criteria.\textsuperscript{163} The broad language of section 12(2) of the Securities Act creates liability without any transactional exemption.\textsuperscript{164} Section 10(b) of the Securities Exchange Act\textsuperscript{165} and rule 10b-5\textsuperscript{166} contain no transactional exemptions and indeed contain broad language rebutting any such implication. The legislative history of the Acts, which indicates a goal of investor protection, provides no evidence of an intent to create a broad transac-

\textsuperscript{158} Id. at 1145. The court referred to the “inherent illusiveness” of the third part of the \textit{Howey} test. Id.

\textsuperscript{159} Id. In Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983), the Fifth Circuit Court of Appeals, relying on the pragmatic arguments presented in \textit{Golden}, joined the Second and Fourth Circuits in rejecting the sale of a business doctrine.

\textsuperscript{160} 673 F.2d 342 (11th Cir. 1982).

\textsuperscript{161} Id. at 343.

\textsuperscript{162} Id. at 344-45.


\textsuperscript{164} Id. § 77i(2) (1976).

\textsuperscript{165} Id. § 78j(b) (1976).

\textsuperscript{166} 17 C.F.R. § 240.10b-5 (1982).
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Although the language and the policy of the Eleventh Circuit are clearer than the definitional analysis of the Seventh Circuit, the King theory cannot be supported.

One general agreement emerges from the analysis of the six circuits that have approached the sale of a business problem. Although the Supreme Court has addressed the issue of defining a security in a number of different contexts, the Court has not made a definitive statement that indicates proper treatment of the sale of a business. The Forman analysis supports security treatment because the stock sold has all the characteristics of an interest so named and listed in the statute. On the other hand, a persuasive argument can be made that the protection of the Acts was not intended to and should not extend to such a transaction. The ultimate issue must be whether judicial use of a limiting definition of a security is an appropriate means to limit the protection of the Acts.

III. THE UNFORESEEN IMPLICATIONS OF THE SALE OF A BUSINESS DOCTRINE

A. The Securities Act of 1933

The basic regulatory scheme of the Securities Act provides that the registration process, which is intended to supply potential investors with the information necessary to an investment decision, must precede the offer and sale of all securities. Certain narrow categories of securities and transactions are exempted from this registration process. These exemptions reflect the judgment of Congress that investors in certain limited situations do not need the protections of the registration process. The Act contains no indication, however, that Congress has determined that an

168. The majority in Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982), provided the strongest rationale for the sale of a business doctrine, but still found it unpersuasive. Id. at 1140. Judge Winter recognized that permitting all stock that has the basic characteristics of stock to be included within the statutory definition of a security results in an overbroad application of the Acts. Id. at 1146. Congress was clearly concerned with protecting market investors who had limited opportunity to obtain the necessary information upon which to base an investment decision. The courts have extended this protection to nonorganized markets and even face-to-face transactions. See Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). The need for such protection is less clear in these situations because first, the buyer has the opportunity to demand the information and, second, because other protective remedies are available in these nonintermediary transactions. The overbreadth is greatest in the sale of a business transaction because the parties are principals and have the leverage to gain information and the sophistication to use it, often unavailable to more passive investors.
170. Id. § 77e (1976). This mandate is enforceable by three distinctly different remedies: private civil liability, id. §§ 77k-77l; public civil equitable remedies, id. § 77t(b); and public criminal action, id. §§ 77(b), 77x.
171. See id. § 77c(a)(1)-(8) (exempt securities); id. §§ 77c(a)(9)-(11), 77c(b), 77d (transactions exempt from process).
vestor who purchases control of a business entity does not need the protection of the disclosure process. An argument that a broad exemption for purchases of control would implement congressional intent could, however, be based on the exemption found in section 4(2) for “transactions by an issuer not involving any public offering.” According to the Supreme Court, Congress created section 4(2) because it believed that wealthy, sophisticated investors can compel disclosure of necessary investment information and do not need the protection of formal disclosure requirements. Three limitations, however, restrict the availability of section 4(2). The offeree must be either wealthy or knowledgeable, the seller must also be the issuer, and resales of the securities are limited by the provisions of section 4(1). A judicial determination that a security was not involved whenever an investor purchased a controlling equity interest would create an exemption not limited to issuers or qualified offerees. The applicability of the disclosure requirements to resale would depend upon the presence or absence of a shift in control.

An example helps to demonstrate the artificiality inherent in use of the definition of a security to create a broad exemption. Assume the merger of corporation A and corporation B. Corporation A is large and closely held and corporation B is large and publicly held. If the assets of B are sold to A for stock in A, and B remains a holding company with control of A, should this transaction be exempt from a prospectus requirement? Does the transaction change materially if the shares of A are not held by B but are distributed to the shareholders of B who individually do not control A? If the transaction is structured as a merger, with shareholders of corporation A holding the controlling interest in the merged corporations, is the need for prospectus information different? If shareholder X, the majority shareholder of A, receives the controlling interest in the merged corporations, does the need for prospectus information change? Under the sale of a business doctrine, no security is involved in these transactions. Any subsequent distribution of shares by the holding company corporations, however, would trigger prospectus requirements as to some of the distributees, because some of the shares would not carry a control feature and thus would be securities. This disclosure would come at a time when no investment decision was made and would thus be useless. Finally, government regulation of disclosure upon resale would become extremely difficult under the sale of a business doctrine because the shares' status as a security would always depend on the percentage of stock purchased by the buyer.

173. The adoption of the sale of a business doctrine would substitute a judicially created exemption for all such transactions irrespective of any analysis of the investor's need for information. The combination of the potential overbreadth of such an exemption and the extra-legislative manner of its creation result in preliminary doubts as to its propriety.
176. 15 U.S.C. § 77d(1) (1976). Resales of securities acquired by control persons who receive them in a transaction exempt under § 4(2) are limited by § 4(1) because that section may cause them to be treated as underwriters. Id.
The likelihood of section 12(1) liability, SEC suits for injunctions under section 20, and potential criminal actions under section 20 would be uncertain, and the viability of the prospectus disclosure scheme would be severely undermined.

The contention that Congress intended to exempt the sale of a business from the federal disclosure scheme could also be based upon the transactional exemption found in section 3(a)(11) for purely intrastate transactions. The limited size of most local corporations and the restrictions on resale of stock support the assertion that transactions in the stock of such corporations by local residents do not need the protection of the disclosure scheme. The intrastate exemption can be viewed in actuality as a close corporation exemption controlled by geographical limits rather than a quasi-federal exemption based upon the adequacy of state control. The statutory language, however, does not support such a rationale. The sale of a business doctrine, which lacks close corporation limitations and contains only questionable resale restrictions, would expand the transactional intrastate exemption beyond recognition.

A final provision of the Securities Act supports rejection of the sale of a business doctrine. Section 12(2) creates liability for misrepresentations and material omissions by a seller even when the disclosure scheme of section 5 does not apply. Congress evidently felt the need for disclosure protection in the secondary market and intended section 12(2) to extend such protection to transactions outside the organized markets. The inadequacies of state tort-misrepresentation theories justify such an approach. The scheme of disclosure in section 12(2) extends to all the securities and transactions exempted by section 3, other than governmental securities. This extension of liability seems to conflict with judicial exclusion of offers and sales of controlling business interests from Securities Act coverage on the grounds that securities are not involved. Although one could argue that a purchaser of control of a business entity has sufficient leverage to compel adequate disclosure in the absence of section 12(2) protection, there is no indication that Congress shared such a belief.

As demonstrated above, the sale of a business doctrine raises difficult problems under the Securities Act that the courts have not yet considered. First, a broad definitional exemption would, in effect, restructure the registration and disclosure scheme in the primary market, especially in business combination cases. The concept of resales of restricted securities would be further complicated by the artificial recategorization of common stock in-

177. Id. § 77f(1).
178. Id. § 77t.
179. Id.
180. Id. § 77c(a)(11).
181. Id. § 77f(2).
182. Id. § 77e.
183. Id. § 77f(2). The short statute of limitations contained in § 13 and the privity requirement inherent in § 12(2) limit to some degree the federal cause of action. Id. §§ 77e, 77f(2).
184. Id. § 77f(2).

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terests as securities or nonsecurities that would occur with each change in the size of the purchaser's interest. Second, the broad exemption scheme created by the sale of a business doctrine would confound SEC prophylactic remedies and create unmanageable uncertainty in the area of criminal penalties. Finally, the rationale behind the alternate disclosure scheme of section 12(2) is inconsistent with creation of an extrastatutory exemption for sales of controlling business interests.

B. The Securities Exchange Act of 1934

The implications of a definitional exemption create more extensive problems under the substantially more complex Securities Exchange Act. The language of the Act can be read, on the surface at least, as lending more support to a limit on investor protection than can the terms of the Securities Act. Section 2 of the Securities Exchange Act states that the national public interest in investor protection extends to "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets." The regulatory scheme of the Act is designed to further that public interest by removing impediments to and protecting the integrity of a national securities marketplace.

An argument can thus be made in favor of limiting application of the regulatory scheme of the Securities Exchange Act to transactions in public markets or to interests of investors that are affected by transactions in such markets. Supporters of the argument must recognize, however, that since this Act does not exempt transactions from the regulatory scheme, the judiciary must implement congressional intent by limiting the definition of a security. The Supreme Court cases defining securities complicate this argument. The Court's inclusion of unconventional interests not sold in national marketplaces within the definition of a security must then be distinguished as based upon the policy underlying a different regulatory scheme, that of the Securities Act. If the broader policy of the Securities Act enunciated in Howey supports a more inclusive definition of a security, then the Howey test established in furtherance of that policy should not be used in a restrictive manner to support the narrower policy of the Securi-

186. Id. § 78b (1976).
187. Id.
188. In SEC v. W.J. Howey Co., 328 U.S. 293 (1946), Justice Murphy stated:
   It [a broad definition of a security] permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." H. REP. No. 85, 73d Cong., 1st Sess., p. 11. It embodies a flexible rather than static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.
328 U.S. at 299.
189. This statement conflicts with the dictum found in Chief Justice Warren's opinion in Tcherepnin v. Knight, 389 U.S. 332 (1967), which states that the two Acts are "virtually identical." Id. at 335-36. Though the language is virtually identical, one must argue that the policy to be served by the different regulatory schemes is different.
ties Exchange Act. If this concern can be overcome by the simultaneous adoption of the Howey test and recognition of the policy underlying the Securities Exchange Act in Forman, then one might conclude that rule 10b-5 is intended to protect only those investors who buy or sell securities that satisfy the Howey tripartite test. Under this approach, the sale of a business doctrine should be used to define securities under the Securities Exchange Act. Since all of the cases to date that have considered the doctrine involved alleged violations of rule 10b-5, perhaps Securities Act problems should be distinguished.

Use of a statutory definition of a security to exempt the sale of a business from a regulatory regime creates problems, however, even if the definition is limited to the Securities Exchange Act. The first potential problem arises in the interpretation of margin prohibitions. The language of the margin provision covers credit extended and maintained as to purchases of securities. Since the sale of a business would not be considered a security, no limit could be placed on credit extended for the purchase of a controlling interest in a public corporation. The Federal Reserve Board’s authority to prescribe rules governing margin transactions should not be curtailed so peremptorily.

The second conceivable difficulty concerns section 13(d) protective devices in potential take-over situations. This section provides notice of acquisitions of substantial interests in publicly traded corporations. The purchase of a security must be reported to the SEC and to the issuer when ownership reaches the level of more than five percent of that class of securities. If the purchase of a controlling block of stock is also the purchase of a business, and is not the purchase of a security, then some of the transactions that the section was intended to reach could be excluded from coverage.

One can only speculate as to the impact of the sale of a business doctrine on section 13(e) of the Securities Exchange Act. This section serves as the jurisdictional base for the promulgation by the SEC of rules on going private. When a corporation goes private it purchases control and usually 100% of its own stock. Under the sale of a business doctrine, in such a situation the corporation would not be purchasing a security, but the seller would be selling one. Such a result seems irrational, but differing treatment of buyer and seller would be necessary to avoid complete nullification of the protective scheme. These transactions highlight the artificiality of the distinctions called for by the sale of a business doctrine, which really should be called the purchase of a business doctrine.

Unexpected problems may also be encountered in proxy solicitation.

190. See supra notes 170-84 and accompanying text for a discussion of Securities Act problems.
193. Id.
194. Id. § 78m(e) (1976).
State laws requiring shareholder approval of mergers necessitate the use of proxies. In all mergers the purchase and sale of a business is the essential goal of the transaction. The SEC's proxy rules, promulgated under the authority of section 14(a), apply to the solicitation of "any proxy or consent or authorization in respect of any security . . . registered pursuant to section 12 of this article." In a merger transaction the authorization sought from the shareholders of the acquiring corporation covers the purchase of assets or common stock of the target business. If such a purchase would not be the purchase of a security, would the proxies be "in respect of" a security? The proxies would actually be in respect of the purchase of a business from the holder of a security in the target corporation. The need for approval by shareholders of the target corporation further complicates the problem. Would these proxies be in respect of a security? Evidently the sale, but not the purchase, of a security would occur in this situation.

The issues discussed above in connection with section 14(a) also arise in the context of tender offers under sections 14(d) and 14(e). The growth of the tender offer as a popular means of acquiring a business, whether used alone or as a prelude to a statutory merger, makes these issues questions of considerable importance. Sections 14(d) and 14(e) apply to "a tender offer for, or a request or invitation for tenders of, any class of any equity security which is registered pursuant to section 12 of this title." The language of section 14(e) that makes unlawful misrepresentations and omissions not only in tender offers but also "in connection with any tender offer . . . in opposition to or in favor of any such offer" further complicates the matter. Although the case law has not yet established exactly which parties possess an implied cause of action for violations of this section, tender offerees and perhaps successful tender offerors could probably bring such a suit if the tender offer involved a security. Since the goal of the offer is the purchase of a business, however, perhaps the offers do not involve a security.

Some of the horrors described above are admittedly based upon the potential expansion of the sale of a business doctrine beyond any of the litigated cases. These expansions are arguably consistent with both the language and rationales of those cases, however. If the Supreme Court cases concerning the definition of a security do not mandate either adopt-
tion or rejection of the doctrine, then the effects of the doctrine on various provisions of the Acts must be considered. Whether these effects militate against adoption of the doctrine or merely indicate the need for substantial limitation of it is an open question.

IV. Conclusion

The sale of a business doctrine is an engaging concept. Even strong believers in investor protection must wonder at the growth of the federal securities laws from an acorn to a judicial oak in less than fifty years. Use of the sale of a business doctrine as a pruning tool, however, might substitute a chainsaw for a branch clipper. In Sutter v. Groen,205 the most recent Seventh Circuit decision on this issue, the court of appeals recognized the need for clarification of the doctrine.206 Judge Posner's opinion for the court suggests that the important distinction between entrepreneurs and investors has been lost.207 Theoretically these two categories of persons have distinct economic functions. The investor places his capital at risk in exchange for a return appropriate to the risk encountered. The entrepreneur, in contrast, combines the investment of capital with innovation and management of the enterprise in which the capital is invested. In a very general sense, disclosure of information is most critical to efficient investment decisions. Interference in the capital market can thus be justified only by the need for investors to gather adequate risk information. The entrepreneur, on the other hand, who may also be investing capital in the enterprise, is motivated primarily by the anticipated return on his innovative management techniques and only secondarily by the anticipated return on his capital. Market interference for the purpose of providing risk information to such a person would not be an efficient utilization of resources.

Judge Posner's analysis indicates that since the Securities Acts were designed primarily to provide risk information to investors, securities should be defined in a manner consistent with protecting only investor interests. The sale of a business doctrine provides a rough method of identifying those situations in which the interest involved is entrepreneurial and risk information disclosure is unwarranted. While Sutter provides a valuable approach to limiting the market interference of the Securities Acts, the distinctions drawn in that case may be difficult to apply to complex financial transactions. In the close corporation setting former owners may be retained in management positions either as part of the compensation paid by a true entrepreneur, as a disguised anticompetitive move by either

205. 687 F.2d 197 (7th Cir. 1982).
206. Sutter was the 70% owner of a corporation that had agreed to purchase 100% of the stock in the corporation in which the Groens were the sole shareholders. Alleging misrepresentations by the Groens in order to induce the sale, Sutter brought suit based on a violation of rule 10b-5. The court, relying on a rebuttable presumption of entrepreneurship because Sutter owned over 50% of a corporation purchasing 100% of another, held there was no purchase of a security and no 10b-5 violation. Id. at 203.
207. Id. at 201.
an entrepreneur or an investor, or as an indication of the pure investor status of the purchaser. In the smaller public corporation the purchase of control may reflect either an entrepreneurial decision based on a recognition that present management has lost its entrepreneurial drive, or an investment with a reserve of entrepreneurial rights exercisable when needed, or an investment with an incidental right of control. In the large public corporation acquisition of control may result from motives ranging from entrepreneurial ambition to conglomerate investment diversification.208

This analysis indicates that significant justifications support the sale of a business doctrine. The cases involving the doctrine do not indicate so clearly, however, that a threshold exemption from all of the protective devices of the Securities Acts is warranted. The classical assumption that entrepreneurs need less risk information than investors may be true in a simpler economic system, but our complex economic world includes arbitrageurs, investment banks, and active representatives of large numbers of passive investors, as well as entrepreneurs and investors. Use of the definition of a security to distinguish these groups may be extremely difficult for the trial courts. In our primitive society allegory, tampering with the definition of a brick after the brick was inserted into a wall told us nothing about the chinks in the wall, the cracks in the brick, or the composition of the mortar. The society desired to attain an adequate supply of effective shelters. Defining the brick as no longer a brick, however, was not the ideal means of achieving that goal.

208. The Suter court suggested a procedural approach to these difficult applications. Id. at 202-03. In cases involving the sale of a business, a presumption would arise that a security was not involved. A purchaser would have the opportunity to rebut the presumption and demonstrate his true investor status. Id. at 203.