REALIGNING FEDERAL AND STATE ROLES IN SECURITIES REGULATION THROUGH THE DEFINITION OF A SECURITY

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I. INTRODUCTION

In Kardon v. National Gypsum Co.,¹ the first case recognizing an implied cause of action for damages under rule 10b-5,² the plaintiffs, who were fifty percent shareholders of a closely held corporation, sold their shares to defendants, the owners of the remaining fifty percent. Both plaintiffs and defendants were active in the business, but plaintiffs did not know that defendants had negotiated independently a deal to sell the company at a price per share significantly higher than the amount defendants had paid plaintiffs. Plaintiffs sued in federal court under rule 10b-5. Defendants argued that section 10(b) of the Securities Exchange Act of 1934³ and the SEC rules adopted thereunder were intended for the protection of “investors,” and that the existing owners of half of the total stock outstanding were not investors within the meaning of the statute or the rule.⁴ The court rejected this argument, however, and held that the plaintiffs had stated a claim.

The defendant in Kardon apparently did not think to raise the argument that the transaction did not involve a “security” within the meaning of the 1934 Act. Indeed, the court presumed that a security was involved in stating, “It is not, and cannot be, questioned that the complaint sets forth conduct on the part of the [defendants] directly in violation of the provisions of Sec. 10(b) of the Act and of Rule X-10B-5

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2. 17 C.F.R. § 240.10b-5 (1982). Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security in interstate commerce, to (i) employ any device, scheme, or artifice to defraud; (ii) make any untrue statement of a material fact or omit a material fact necessary in order to make the statement not misleading; (iii) engage in any act, practice or course of business which operates as a fraud or deceit upon any person.
4. 69 F. Supp. at 514.
which implements it." Such conduct, of course, must necessarily be in connection with the purchase or sale of a security.

In the intervening years, the spectacular rise of rule 10b-5 and its subsequent partial fall have been documented well. A number of commentators have questioned in particular the policy basis for applying rule 10b-5 to transactions in the shares of a closely held business enterprise, and several well-known Supreme Court cases have severely limited rule 10b-5's applicability in particular circumstances. No judicial principle, however, has emerged that would specifically remove cases like Kardon from the reach of rule 10b-5 on the ground that federal law simply has no useful role to play in regulating the routine frauds that often accompany transfers of shares in close corporations. Indeed, the cases continue to hold generally that the rule does apply to such transactions.

A recent series of cases, however, represents a serious flanking attack on this proposition. Although these cases do not clearly identify the policy basis for their results, they all attempt to establish the "sale of business doctrine," which holds that the acquisition of 100% or perhaps even a controlling block of a business' stock does not constitute the purchase of a security by the buyer. A finding that no security is

5. Id. at 513.
involved in the transaction, of course, removes the jurisdictional basis not only for actions brought under rule 10b-5 but also for actions brought under any other provision of the federal securities laws. The implications of the sale of business doctrine for cases like *Kardon* are significant.12

The doctrine has other implications as well. Even assuming an unstated policy goal of returning to the states sole jurisdiction over the affairs of closely held corporations and their shareholders, the logic of the sale of business doctrine is not easily restricted to close corporation cases, nor does the doctrine eliminate all such cases from the purview of federal securities law. Perhaps even more important, the similarity of most state law definitions of the term "security" to the definitions under federal law implies either that the states must interpret similar statutory language differently from the federal courts' interpretation of the sale of business doctrine, or that these transactions will escape the reach of state securities regulation as well. The trend is very firmly in the latter direction, and the result is to remove from sale of control transactions all of the advances in antifraud protection that both federal and state securities laws have provided over the common law.

This article examines technical and policy bases of the sale of business doctrine. It concludes that, at least technically, neither the statutes nor the Supreme Court cases concerning the definition of a security justify the sale of business doctrine. The article then addresses the question of whether there is some policy basis for deviating from the long-standing interpretation that stock in an ordinary profit-making corporation is a security and finds few reasons to justify singling out sale of control transactions for special treatment. The apparent policy basis for the sale of business doctrine, to realign federal and state roles in securities regulation, is only partially achieved and only at a cost of significant theoretical and practical side effects. This article concludes that a goal of eliminating a federal judicial role in regulating transactions in shares of closely held corporations is probably attainable only through statutory or rule amendment. Nevertheless, at least until re-

12. In a case strikingly similar to *Kardon*, a federal district court held that the absence of a security transaction under the sale of business doctrine precluded suit under rule 10b-5. *See Barys v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981), where a relatively inactive 50% shareholder sued the shareholder in charge of day-to-day operations after both had sold their shares to a third party, who acquired all the corporation's outstanding shares (including those of an eight percent shareholder not a party to the litigation). Plaintiff claimed that defendant failed to disclose receipt of a premium in the form of a lucrative employment contract, but the court held that the absence of a security transaction under the sale of business doctrine precluded suit under rule 10b-5. *See infra* text accompanying notes 80-83.
cently, the bandwagon of courts embracing the sale of business doctrine seemed beyond derailment.\textsuperscript{13} Consequently, unless the judicial trend reverses direction, the most rational approach to achieving such a policy goal is through an amendment of the federal securities statutes. The amended statutes should explicitly include within the federal definition of the term “security” all shares of stock of ordinary profit-making corporations, but should exclude application of the federal provisions to shares of closely held corporations. The states would then be in a position to choose more rationally the kinds of transactions that would remain subject to the state schemes of securities regulation.

II. EMERGENCE OF THE SALE OF BUSINESS DOCTRINE

\textit{A. Statutory Structure}

Congress enacted the federal securities laws nearly fifty years ago. While both the 1934 Act and its forerunner, the Securities Act of 1933,\textsuperscript{14} have generated voluminous litigation and commentary, the basic regulatory structure of these two statutes has remained essentially unchanged. The 1933 Act requires that a registration statement be in effect whenever any security is sold unless the security itself or the particular transaction falls within one of the statutory exemptions.\textsuperscript{15} The 1933 Act also prohibits the employment of fraudulent devices or material misrepresentations or omissions in the offer or sale of any security, and expressly provides that the antifraud provisions apply to securities that are otherwise exempt from the regulatory provisions of the Act.\textsuperscript{16} The regulatory scheme of the 1934 Act is aimed broadly at the national securities markets, and, pursuant to section 12, requires registration of classes of securities that are either traded on a national securities exchange or are held by more than 500 persons.\textsuperscript{17} Thus, the requirement

\textsuperscript{13} The recent Second Circuit opinion by Judge Winter in Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982), refusing to accept the sale of business doctrine, indicated a significant break in the earlier, nearly uniform trend towards its adoption, but even that case evoked a strong dissent from Judge Lumbard. Moreover, the Seventh Circuit has recently reaffirmed its prior adoption of the doctrine in Sutter v. Groen, 14 Sec. Reg. & L. Rep. (BNA) 1557 (7th Cir. 1982) (Posner, J.), in the light of both \textit{Garafalo} and the Supreme Court’s most recent decision on the question of what constitutes a security, Marine Bank v. Weaver, 102 S. Ct. 1220 (1982).


\textsuperscript{15} \textit{Id.} §§ 77c, 77d, 77e; §§ 3, 4, 5 of the 1933 Act.

\textsuperscript{16} Sections 12(2) and 17 of the 1933 Act constitute the general antifraud provisions. Section 12(2) authorizes a civil claim for rescission or damages against the seller who employs any material misrepresentation in the offer or sale of a security “whether or not exempted by the provisions of section 3” (the exempt securities provisions), except securities exempt under § 3(a)(2), which covers various government and bank securities. Furthermore, it has long been held that § 12(2) applies to securities sold in transactions exempt from registration. \textit{E.g.}, Securities Act Release No. 5487 (Apr. 23, 1974) (adopting former rule 146 and expressly stating that § 12(2) applies to transactions exempt thereunder). Section 17 is a general provision making unlawful the employment of fraudulent devices and misrepresentations in the offer or sale of securities, and § 17(e) expressly provides that the exemptions under § 3 do not apply to § 17. 15 U.S.C. §§ 77l, 77q (1976).

\textsuperscript{17} 15 U.S.C. §§ 78l(b) & (g) (1976). It is important to bear in mind that the concept of
for periodic filing of reports,\textsuperscript{18} the regulation of proxy solicitations,\textsuperscript{19}
the takeover regulations,\textsuperscript{20} and the statutory insider trading rules\textsuperscript{21} apply
only to companies that have a class of security registered under section 12 of the 1934 Act. The 1934 Act thus is aimed primarily at the
regulation of transactions involving securities issued by publicly held corporations.

A major exception to the regulatory scheme of the 1934 Act appears in the antifraud provision of section 10(b). That section authorizes the Securities and Exchange Commission to adopt rules prohibiting the employment of manipulative or deceptive devices "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered."\textsuperscript{22} Thus, the antifraud provisions of the 1934 Act were clearly intended, and
have always been interpreted, to apply to more than just the publicly held securities that are registered under section 12. The scope of section 10(b) and the SEC rules adopted thereunder has been the subject of considerable debate. The analytical framework of the debate, however, has centered on such issues as the policy basis for applying rule 10b-5 to transactions in shares of closely held corporations,\textsuperscript{23} the wisdom of recognizing implied rights of action under such SEC rules,\textsuperscript{24} and the elements of any such private claims in light of the express civil liability provisions of the overall regulatory scheme.\textsuperscript{25}

The conceptual structure of both the 1933 Act and the 1934 Act thus sharply distinguishes securities from transactions in securities,\textsuperscript{26} although the presence of a security, as opposed to property in general, is necessary before the regulatory provisions become applicable to any transactions.\textsuperscript{27} The 1933 Act and the 1934 Act define the term "security" in very similar language,\textsuperscript{28} and courts have interpreted the two def-

\begin{footnotesize}
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\item Id. \S\ 78m(a)-(c).
\item Id. \S\ 78n(a)-(c).
\item Id. \S\S\ 78m(d), 78n(d).
\item Id. \S\ 78p(a), (b).
\item Id. \S\ 78j(b) (emphasis added).
\item See authorities cited supra note 7.
\item E.g., Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U.L. Rev. 627, 642-51 (1963).
\item E.g., A. Jacobs, Litigation and Practice Under Rule 10b-5 \S\S\ 36-40 (5 Securities Law Series 2d ed. 1981); Ruder, supra note 24, at 671-84.
\item See Dillport, Restoring Balance to the Definition of a Security, 10 SEC. REG. L.J. 99, 120-33 (1982).
\item In Marine Bank v. Weaver, 102 S. Ct. 1220 (1982), the Supreme Court cautioned again that in enacting the securities laws, Congress "did not intend to provide a broad federal remedy for all fraud." Id. at 1223 (citing Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1253 (9th Cir. 1976); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974)).
\item Section 2(1) of the 1933 Act, 15 U.S.C. \S\ 77b(1) (1976); and \S\ 3(a)(10) of the 1934 Act, 15 U.S.C. \S\ 78c(a)(10) (1976) provide the definitions of "security."
\end{enumerate}
\end{footnotesize}
initions coextensively. 29 Section 2(1) of the 1933 Act defines a security as follows:

[Un]less 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, reorganization 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. 30

Consequently, the threshold question in any case is whether the transaction or instrument in question is covered by any of the items in this catalogue. If not, the transaction is not subject to the regulatory coverage of the federal securities statutes.

Because the sale of business doctrine restricts the definition of a security, it attacks the federal jurisdictional question at its most critical point. Moreover, to the extent that the doctrine centers on factors traditionally considered to be relevant only to exemption provisions, such as the number of purchasers or sellers, the doctrine undercut s the federal statutes' basic structure that distinguishes between securities and transactions in securities, and between the broad application of the antifraud provisions and the much narrower application of the registration and related provisions.

B. Supreme Court Interpretations

Two lines of cases are germane to an understanding of the recent emergence of the sale of business doctrine. The first line consists of those cases interpreting the term "investment contract," which appears in the definitional catalogue and has traditionally served as a catchall to bring within the federal regulatory scheme many unusual transactions involving such diverse subject matters as chinchilla breeding, scotch whiskey, beef and dairy cattle, precious gems, and condominiums. The fountainhead of this line is SEC v. W.J. Howey Co., 31 a 1946 Supreme Court case involving the sale of managed orange groves. The Court held that "economic reality" is a key to determining whether a transaction not fitting within one of the more usual securities categories might nevertheless be classified as an investment contract. Specifically,

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29. See Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967); Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 431 (9th Cir. 1978).
the Court said that the test for an investment contract under federal securities law involves four elements: (1) an investment of money in (2) a common enterprise with (3) an expectation of profit from (4) the efforts of others.\textsuperscript{32} The litigation and scholarly commentary over the various elements of the \textit{Howey} test have been voluminous. It is important to understand, however, that the Court in \textit{Howey} did not purport to define any item in the definitional catalogue other than "investment contract."

The second line of cases is the often discussed series of Supreme Court cases decided since the mid-1970's that severely cut back the scope of federal securities regulation. By limiting remedies,\textsuperscript{33} increasing standards of proof,\textsuperscript{34} restricting standing,\textsuperscript{35} reducing the scope of applicability,\textsuperscript{36} and refusing to expand implied private causes of action beyond those already recognized,\textsuperscript{37} the Court has indicated that federal securities laws are neither panaceas for all of society's economic problems nor means for regulating matters that traditionally have been relegated to the states.\textsuperscript{38}

One Supreme Court case, \textit{United Housing Foundations, Inc. v. Forman},\textsuperscript{39} decided in 1975, bridges the gap between these otherwise independent lines of judicial decisions. \textit{Forman} involved state-subsidized cooperative housing rights that were evidenced by certificates or shares formally denominated as "stock" but lacking most of the attributes of stock in a profitmaking corporation. The lower court, following a literal approach to statutory interpretation, concluded that the label "stock" on the certificates brought them within the coverage of the securities laws because the word "stock" appears in the definitional catalogue.\textsuperscript{40} The Supreme Court refused to accept this interpretation of the scope of the statutes and held that the term "stock" did not cover the rights involved in \textit{Forman} because they were non-transferable, non-voting, and provided no opportunity for later dividends or sale at a profit. In the language of section 2 of the 1933 Act, "the context otherwise require[d]" that these rights be excluded from the definition. The "economic reality" of the housing certificates in question put them well outside what Congress had in mind when it included the term "stock" in the definitional catalogue.\textsuperscript{41}

Having concluded that the low-cost housing shares in question

\textsuperscript{32} Id. at 299.
\textsuperscript{33} Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975).
\textsuperscript{34} Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
\textsuperscript{35} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
\textsuperscript{36} Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).
\textsuperscript{38} Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).
\textsuperscript{39} 421 U.S. 837 (1975).
\textsuperscript{40} Forman v. Community Servs., Inc., 500 F.2d 1246, 1255 (2d Cir. 1974).
\textsuperscript{41} Id. at 848-51.
were not "stock," the Forman Court went on to consider whether the certificates were an "investment contract" within the meaning of the statute. In this analysis, the Court applied the Howey test and concluded that the expectation of profits element was not met.\(^{42}\) Because no other term in the definitional catalogue was even arguably applicable, the housing shares were not with the purview of the federal securities laws. The Forman analysis thus involved a two-step procedure: first, the Court concluded that the shares in question were not "stock," and then the Court analyzed whether, under Howey, the interests in question fell within the "investment contract" characterization.\(^{43}\) The Court did not apply the Howey test in determining whether the interests constituted "stock" under section 2(1). Nevertheless, the Forman Court's nonliteral approach to the term "stock" in the definitional catalogue has been the lynchpin of the analysis favoring the sale of business doctrine. This analysis bridges the gap between the retrenchment cases and the Howey investment contract cases by applying the Howey test to all of the items in the catalogue.\(^{44}\)

Thus, while the Supreme Court has indicated philosophical displeasure with the ever expanding federalization of corporate law under the securities statutes, the common practice of the federal courts until recently has been to read each term in the definitional catalogue on its own. Whether particular transactions would be subject to federal securities regulation depended on the courts' interpretation of the ordinary and technical possibilities for the term in question in light of the economic realities of the specific instrument or transaction and the overall protective purposes of the securities laws.\(^{45}\)

\section*{C. The Sale of Business Cases}

The recent decisions adopting the sale of business doctrine take an approach very different from that of earlier cases in their interpretation of the word "stock" in the definitional catalogue. The typical transaction in these cases consists of, or at least includes, the sale by the former

\(^{42}\) Id. at 858.

\(^{43}\) See Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982); Dillport, supra note 26, at 107, 115.

\(^{44}\) The Forman Court did equate, for the purposes of that case, the terms "investment contract" and "instrument commonly known as a 'security.'" 421 U.S. at 852, but both phrases explicitly appear in the definitional catalogue. The equivalence of two such catchall phrases hardly requires that every other term in the catalogue be identical. The one line in Forman that does support the gap-bridging efforts of the cases upholding the sale of business doctrine states, in the context of the equivalence of these two phrases, "This test [Howey], in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security." Id. Because the Court has had very little occasion to define any of the terms in the definitional catalogue other than "investment contract" and similar catchalls, and because the Court had not applied the Howey test in the immediately preceding discussion of whether the housing shares were "stock," this sentence also provides little support for the sale of business doctrine. But see Golden v. Garafalo, 678 F.2d 1139, 1148 (2d Cir. 1982) (Lumbard, J., dissenting).

\(^{45}\) See, e.g., infra text accompanying notes 60-67 for the discussion of lower courts' interpretations of the term "note" in the definitional catalogue.
shareholder or several former shareholders of a control block of stock, often 100%, of a closely held but otherwise ordinary, profit-making business corporation. Although the transactions are generally exempt from the registration provisions of the 1933 Act, the dissatisfied buyer often attempts to sue the seller or sellers of the stock under the various antifraud provisions, usually rule 10b-5. Because neither section 10(b) nor rule 10b-5 is limited in operation to securities registered under section 12 of the 1934 Act, it has generally been assumed that rule 10b-5 applies to transactions in securities of closely held companies.46 Without directly attacking the operative scope of rule 10b-5, defendants in the sale of business cases recently have had considerable success in obtaining dismissals of these suits on the ground that the buyer did not purchase a “security.”47

The analytical approach of the federal courts that have accepted the arguments of these defendants in essence combines into one grand “economic realities” test the test of Howey, which dealt with the definition of an investment contract, with that of Forman, which independently considered both stocks and investment contracts. In application, the economic realities test turns out to be the original Howey approach, but no longer limited to investment contracts. In determining whether the purchaser bought “stock” within the meaning of the definitional catalogue, these courts purport to look at the economic realities of the fact situation. If it appears that one party (for example, the buyer) has or will have sufficient managerial control over the enterprise after the transaction that he cannot be said to be dependent on the efforts of others (element four of the Howey test) for his expectation of profit, no security is involved.48 Moreover, when there is only a single purchaser, the transaction may fail the common enterprise test (element two of Howey).49 According to these courts, the purchaser has simply bought an existing business, and the stock transaction is merely one of several “indicia of ownership”50 of that business, not, in economic reality, a security subject to federal regulation.

46. See supra text accompanying note 9.
47. See supra cases cited note 11.
50. E.g., Frederiksen v. Poloway, 637 F.2d 1147, 1151 (7th Cir.), cert. denied, 451 U.S. 1017 (1981); Chandler v. Kew, Inc., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. 1977). The most recent sale of business case, Sutter v. Groen, 14 SEC. REG. & L. REP. (BNA) 1557 (7th Cir. 1982), may have departed from this general analytical approach in setting up an “investor/entrepreneur” distinction for determining what instruments formally labeled “stock” constitute securities. See infra note 106.
III. TECHNICAL DIFFICULTIES WITH THE SALE OF BUSINESS
DOCTRINE

A. Statutory Language and Interpretation

The Supreme Court often states that in determining the scope of the federal securities laws first recourse must be made to the language of the statute itself.\(^{51}\) Here the sale of business doctrine, which applies the \textit{Howey} investment contract test to all of the items in the definitional catalogue, runs immediately into the technical objection that there was no need for Congress to provide such an extensive list if all Congress intended to cover were transactions that fit within the four elements of \textit{Howey}.\(^{52}\) Indeed, \textit{Howey} was decided near the beginning of the era in which federal courts thought it philosophically important to expand the range of protection offered by the federal securities statutes. It is anomalous, therefore, to use the investment contract definition of \textit{Howey} as a lever for restricting the application of federal law in areas in which no one had initially even thought to question applicability. The analysis of \textit{Forman} does not require that the investment contract definition be applied universally in the definitional catalogue, nor does the emphasis on "economic reality" logically require that the realities be the same or fit within the identical formula in every case to which the federal securities regulatory scheme applies.

Flexibility in determining the economic realities of unusual transactions, especially those that are widely offered, is necessary to ensure that the ingenuity of lawyers does not permit escape from the regulatory scheme. However, absent unusual circumstances such as those in \textit{Forman},\(^{53}\) the economic reality of common stock in profit-making cor-

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\(^{52}\) See Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982).

\(^{53}\) In addition to \textit{Forman}, Ellis v. Henderson, \textit{FED. SEC. L. REP.} (CCH) \$ 97,722 (W.D. Okla. 1980), involved a transfer of "stock" that did not incorporate the rights normally associated with stock in profitmaking companies. In \textit{Ellis} the stock itself was ordinary corporate stock, but the plaintiffs purchased only one share for $25,000 while the defendants retained some 1000 shares. The defendants were obligated under the agreement to help the plaintiffs get started in a similar business in another city. The trial court found that the stock transaction was mere form that provided no expectation of dividends or capital growth for plaintiffs nor any voice in the operation. (Note that the absence of participation in control in this case was held to be a factor \textit{against} being treated as a security, which, of course, is precisely contrary to \textit{Howey}). Because the share appears not to have been worth anything near the $25,000 that plaintiffs paid for it, which would have implied a value for the company in excess of $25 million, this conclusion seems justified. Here the economic realities show that the form is different from the substance, not because the \textit{Howey} test is unsatisfied but because the excessive price shows that the plaintiffs were buying something in addition to the share of stock, which alone meant nothing to them. The nonliteral approach of \textit{Forman}, therefore, supports the argument that the share was not "stock," or, more precisely, that the stock was merely a formal and unnecessary appendage to the purchase of something else. Similarly, if the parties simply incorporate a single asset and transfer the stock, the transaction might be excludable from a securities characterization on the ground that the shares are not in a corporation intended to be operated for profit and, therefore, do not carry with them the normal accoutrements of "stock." This would quell the fear expressed in Golden v. Garafalo,
corporations usually is the form of the instrument itself. The instrument defines the holder's rights not only as against any other stockholders in the corporation but also as against the company's creditors and others who do business with the company. Absent more specific agreement, the instrument also defines the relative rights of control over the enterprise. The emphasis of Howey on control by others is, therefore, particularly inappropriate for determining when "stock" should be considered a security. Many of the provisions of the 1934 Act are aimed precisely at a perceived problem in shareholder democracy and at increasing the amount of control exercised over a publicly held corporation by its shareholders.\textsuperscript{54} No one would seriously argue that increasing shareholder participation and control over the enterprise through stronger shareholder democracy provisions should render public shareholders ineligible for the protection of the federal securities laws. In fact, the Supreme Court ruled recently that a bank certificate of deposit, unlike a withdrawable share in a savings and loan association,\textsuperscript{55} was not a security in part because it lacked the voting rights attached to the savings and loan shares.\textsuperscript{56} In addition, an emphasis on control would logically exclude the attacking company in a tender offer as a purchaser of securities. Indeed, a very similar argument was made and rejected in a recent case involving the transfer of a controlling block comprising thirty-eight percent of the outstanding shares of a publicly held corporation.\textsuperscript{57} Federal courts seem unlikely to hold that the acquiring company does not purchase a security in tender offers, but the sale of business doctrine does not logically exclude this transaction, and it is difficult to see exactly where and how a line can be drawn.\textsuperscript{58} Finally, even in closely held businesses, cumulative voting and shareholders' agreements can provide for a significant degree of participation by minority shareholders in company affairs. If control is to be the basis for excluding such holdings from the "security" characterization, the holders of non-voting preferred shares in close corporations might have the protection of federal securities laws, while minority voting common shareholders might not have such protection. Such a distinction has little basis in logic.\textsuperscript{59}

521 F. Supp. 350, 358 (S.D.N.Y. 1981), rev'd, 678 F.2d 1139 (2d Cir. 1982), that such a transaction would fall within the ambit of securities regulation.

\textsuperscript{54} The proxy rules are the prime example. \textit{See} § 14(a)-(c) of the 1934 Act, 15 U.S.C. § 78n(a)-(c) (1976); and the SEC rules adopted thereunder, 17 C.F.R. 240.14a-1 to 14a-12 (1982).

\textsuperscript{55} Therepin v. Knight, 389 U.S. 332 (1967).

\textsuperscript{56} Marine Bank v. Weaver, 102 S. Ct. 1220, 1224 (1982). \textit{See infra} text accompanying notes 84-106.

\textsuperscript{57} Alna Capital Assocs. v. Wagner, 532 F. Supp. 591 (S.D. Fla. 1982).

\textsuperscript{58} The Eleventh Circuit, in one of the most recent sale of business cases, has said expressly that numbers are not determinative and that a sale of less than 100% of the stock might not be covered by the securities laws. King v. Winkler, 673 F.2d 342, 346 (11th Cir. 1982). Thus, under the sale of business doctrine, each case must be evaluated on its own facts.

\textsuperscript{59} In McGrath v. Zenith Radio Corp., 651 F.2d 458, 467 n.5 (7th Cir.), cert. denied, 102 S. Ct. 136 (1981), where a minority shareholder had sold his shares as part of a transaction in which
The Howey investment contract test is inappropriate not only for determining when stock is a security but also for interpreting the term "note," which is the other item in the definitional catalogue that has generated voluminous litigation. Courts, for example, have long recognized that Congress never intended the regulatory coverage of the federal securities laws to extend to notes issued by consumers in connection with the purchase of their personal residences or similar items held for personal use and not principally for investment. The Howey test, however, is not easy to apply generally to promissory notes. The expectation of profits element is especially nettlesome in this context. In the investment contract cases, the Supreme Court has stated that profit under the Howey test involves either an expectation of capital appreciation or some form of participation in the earnings of the company. Neither of these forms of profit is necessarily the primary or even a principal motive for an investment in long-term, fixed income, debt instruments that are publicly issued, but there is no doubt that Congress intended such issues to be included within the coverage of the federal securities laws.

Some principle, therefore, is necessary for distinguishing the public issue of fixed return debt instruments from ordinary corporate and consumer loans involving similar terms. Most courts have adopted the so-called "commercial/investment" distinction for this purpose, but this distinction is not without its problems. In the best reasoned judi-

the purchaser acquired 100% of the shares, the Seventh Circuit distinguished the most widely cited case upholding the sale of business doctrine, Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981). The court in McGrath concluded that the minority shareholder had indeed sold a "security," notwithstanding that the purchaser may not have purchased one. Accord, Stacey v. Rogers, 542 F. Supp. 48 (E.D. Mich. 1982). The commentators supporting the sale of business doctrine also conclude that federal law should protect minority investors in small businesses. See Seldin, supra note 10, at 679; Comment, supra note 11, at 311. But see Barsy v. Verin, 508 F. Supp. 952 (N.D. Ill. 1981), discussed infra in text accompanying notes 80-83.


62. The promissory note cases are extensive in number, and some courts purport to take a "risk capital" approach rather than make the "commercial/investment" dichotomy. The results do not seem too different, however. See generally Seldin, supra note 10, at 639 n.7; Schneider, The Elusive Definition of a "Security", 14 REV. SEC. REG. 981, 984-86 (1981); Lipton & Katz, supra note 60. The point for present purposes is that most promissory note cases do not purport to apply the Howey test directly, although some have considered the Howey factors relevant to the analysis. See, e.g., Braniff Airways, Inc. v. LTV Corp., 479 F. Supp. 1279, 1287 (N.D. Tex. 1979). But see Meason v. Bank of Miami, 652 F.2d 542, 547-50 (5th Cir. 1981), cert. denied, 102 S. Ct. 1428 (1982) (stating that Howey should not be invoked ritualistically across the board); Briggs v. Sterner, FED. SEC. L. REP. (CCH) ¶ 98,444 (S.D. Iowa 1981) (stating that Howey has no application to note transactions).

63. See Zabriskie v. Lewis, FED. SEC. L. REP. (CCH) ¶ 94,902 (10th Cir. 1974); La Salle
cial opinion setting forth standards as to when notes constitute securities, Judge Friendly of the Second Circuit argued for an approach that has since been termed the “new literalism.” Judge Friendly’s opinion interprets the statutory language “unless the context otherwise requires” in the definition of a security as placing on the person seeking an exception the burden of proving that an instrument listed in the definitional catalogue is outside the intended scope of federal securities regulation. This approach does not conflict with the holding of Forman nor does it reject an examination of economic realities in determining whether a particular instrument is a security. On the contrary, the approach follows the Supreme Court’s admonition to begin the analysis with the language of the statute. While Judge Friendly’s new literalism has yet to preempt the field in determining what types of notes are securities, the courts that continue to follow the commercial/investment distinction remain concerned primarily with putting content into that distinction rather than with applying Howey directly to all promissory notes.

Consequently, applying the Howey test for investment contracts across the board in the definitional catalogue simply does not comport with the statutory structure or with the case law interpreting it. The issues therefore are whether there is a substantial policy reason for determining the economic reality of ordinary common stock transfers on a case-by-case basis using the Howey factors, and, if so, whether that

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65. Exchange Nat’l Bank v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976). One presumes the party carrying the burden would invoke factors similar to those arising under the commercial/investment and risk capital approaches, in addition to any “family resemblance” to consumer notes or others generally agreed not to constitute securities. Id. at 1138.

66. Id. at 1137.

67. See, e.g., American Fletcher Mortgage Co. v. United States Steel Credit Corp., 635 F.2d 1247, 1254 n.8 (7th Cir. 1980), cert. denied, 451 U.S. 911 (1981) (expressly rejecting the approach of Judge Friendly in Exchange Bank); National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295, 1301 (5th Cir. 1978) (rejecting an invitation to adopt the Exchange Bank approach, although the court determined that the result would not have been different).

policy reason justifies both the effort of making the determination and the jurisprudential effects that may accompany such an approach.

B. Form Versus Substance

Courts and practitioners generally assume that pure sales of assets, whether by a sole proprietorship, a partnership, or a corporation, do not involve sales of securities and do not invoke federal securities law jurisdiction. A basic policy question is, therefore, whether a transaction involving a controlling block of stock in a profit-making business enterprise is realistically any different in its economic terms and conceptions from one involving all of the assets of that business. A fundamental conceptual distinction between the two transactions is, of course, that assets can normally be acquired without concurrently taking on all of the liabilities of the old business, while liabilities follow naturally from an acquisition of stock and from the fundamental concept of the corporation as a separate legal entity.69 The value of tangible assets should be apparent, at least most of the time, to the purchaser upon an inspection of the assets being acquired; but inspection of a stock certificate does not reveal very much about its value, even if one has independently examined the tangible assets. The fact that the inherent value and risks associated with a purchase of stock are not readily apparent from an examination of the certificate is probably the principal reason that a regulatory scheme exists aimed specifically at transactions in securities. In this sense, the policy for the application of securities regulation is no different from that presented by Howey, where the value of the investment contract presumably could not have been determined from an inspection of the actual physical assets purportedly being sold.

It is, of course, true that the difference between assets and stock transactions is often purely formal, particularly in the close corporation context. Nevertheless, the Howey opinion itself is authority for the proposition that courts should not look to the specific transactional motivations of the parties in determining whether a security was offered or sold. What made the sale of the citrus groves in Howey an investment contract was the offer of a management contract by the company selling the underlying parcels of real property. The purchasers in Howey were not required to accept the management contract and could have purchased the land without it; they were also free to hire other management companies, and, in fact, a significant percentage of the purchasers in that particular deal actually did so.70 Consequently, even under traditional investment contract analysis, the form of the


70. Only 85% of the land buyers in Howey elected to take the management contract. 328 U.S. at 295.
transaction is not without significance. It seems clear, in view of the stock market collapse that led to the adoption of the securities laws, that Congress had stock in ordinary profit-making corporations in mind when it adopted the statutes. Regardless of whether most members of Congress were focusing on publicly held corporations, it did not structure the statutes to limit their application to such corporations. As Kardon shows, it seemed obvious to most observers at the time that ordinary corporate stock was a security. Today it is a little late for courts to be determining that form does not count in connection with an instrument that has been considered from the very beginning to be subject to the regulatory scheme.

Two commentators supporting the sale of business doctrine have argued that substance over form considerations require treating only minority shareholders in closely held enterprises as security owners entitled to federal protection. This argument ignores the reality of many transactions and has implications that are simply contrary to established law. The argument is unrealistic because investments in such enterprises are often made in the form of stock or convertible debt by, for example, venture capitalists who are more capable than a typical buyer of an entire business of making intelligent investment decisions. In addition, buyers such as venture capitalists usually have the economic bargaining power to ensure that they receive whatever degree of control or monitoring power they feel is necessary to secure their investment. There is little policy basis for granting the federal forum to such sophisticated investors while denying it to others simply because they buy all, rather than part, of the stock of a business. What the buyer will do after the transaction should not be crucial in determining whether federal antifraud rules apply. The real issues, rather, are whether the buyer got what he thought he was purchasing, and, if not, whether there is a need for federal remedy. If federal law regulates fraud in one of these cases, it should apply equally in the other. Consequently, the emphasis on subsequent operational control that the sale of business doctrine employs, through the application of Howey to stock transfers, is misplaced.

Moreover, the substance over form argument in support of the sale

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71. Seldin, supra note 10, at 680; Comment, supra note 11, at 311-12.
72. This argument also introduces an asymmetry into sale of business transactions. See infra text accompanying notes 77-83.
74. Howey's control element and common enterprise requirement prevent characterization as a security under the sale of business doctrine when a single buyer purchases all of the stock. Seagrave Corp. v. Vista Resources, Inc., 534 F. Supp. 378, 383-84 (S.D.N.Y. 1982). If one considers only the situation of the purchaser after the acquisition, neither of these Howey elements can ever exist in the case of a successful tender offer for 100% of the outstanding stock; yet such a transaction is certainly one for which federal law should and does show considerable concern. The important policy distinction is the type of corporation involved (public versus private) rather than the purchaser's managerial rights after the transaction.
of business doctrine proves too much. If the concern were solely for persons who invest money in some sort of business that is operated by others, the sale of a general partnership interest or of a simple joint interest in tangible property by an inactive investor should be considered a securities transaction. Indeed, the argument in support of this proposition is even stronger than that favoring the sale of business doctrine because the term "partnership interest" does not appear in the definitional catalogue. The qualification of a partnership interest as a security must, therefore, be determined by reference to the traditional catchalls, which usually mean the Howey test applied to investment contracts. A silent general partner surely can be said to have invested money in a common enterprise (with his partners) with the expectation of profits (participation in earnings) from the efforts of others (the active partners). Yet, the cases quite uniformly hold that general partnership and joint venture interests are not investment contracts regardless of the degree of actual control exercised, provided the legal right to some participation in the business is retained. Moreover, a number of cases upholding the sale of business doctrine hold or strongly imply that it is the power to exercise some degree of control, rather than actual exercise of control, that takes the transaction out of the securities classification. It would be reasonable to adopt a flexible approach to general partnership interests, joint ventures, and common tenancies in property when seeking to determine whether the participation required by the Howey test was met in fact and not just in legal theory. However, because the traditional approach even under the Howey test for investment contracts looks solely to the form of the interest, i.e., legal rights under the partnership or joint venture agreement, substance over form provides no basis for extending the Howey test to the term "stock" in the definitional catalogue.


C. Asymmetrical Nature of Securities Transactions

In applying the *Howey* test to the term “stock” in the definitional catalogue, courts upholding the sale of business doctrine have introduced a disconcerting asymmetry into securities transactions in that one party to a transaction may be dealing in a security while the other is not. For example, five or ten equal shareholders, none of whom individually has sufficient actual power to control the operation of the company, would, under almost any analysis, be considered holders of securities. If they sell all their shares to a single purchaser who assumes complete control, the sale of business doctrine would hold that the buyer has not purchased a security, but the doctrine would not exclude the sellers from the protection of the securities laws.\(^{77}\) This leads to the anomalous situation that the sellers can sue in federal court under federal law for any misrepresentations made by the buyer during the transaction, but the buyer cannot do the same with respect to the sellers, notwithstanding that it is much more likely that the sellers, or some group of them, have more accurate knowledge concerning the operations and financial condition of the company than does the buyer. One commentator has stated that the strangeness of this asymmetry is “largely superficial” and, in any event, consistent with an analysis that hinges the finding of a security on the absence of control by shareholders who are not active in the business.\(^{78}\) Nevertheless, the conceptual difficulties have already led a number of courts to indicate that they might balk at such an asymmetrical characterization of the transaction.\(^{79}\) Yet, under the sale of business doctrine the only way to avoid the asymmetry is to hold arbitrarily that whenever any party to a transaction either buys or sells a control block of stock, neither buyer nor seller is involved in a securities transaction. This, of course, comports with the statutory structure that distinguishes between securities and transactions in securities but negates the economic realities test of *Howey* that constitutes the basis for the sale of business doctrine in the first place.

Nevertheless, this precise rationale underlies the recent decision in *Barsy v. Verin*.\(^{80}\) Plaintiff Barsy was the owner of fifty percent of the shares of a closely held corporation, while defendant Verin owned only forty-two percent but was in charge of the day-to-day operations of the business. A third eight percent shareholder was not a party to the liti-

\(^{77}\) McGrath v. Zenith Radio Corp., 651 F.2d 458, 467 n.5 (7th Cir.), cert. denied, 102 S. Ct. 136 (1981) (the court expressly held that the sale of business doctrine does not extend this far). *But see* cases cited infra note 79.

\(^{78}\) Seldin, *supra* note 10, at 681 n.107.


gation. Relations between plaintiff and defendant had soured, and ultimately at defendant's suggestion the parties sold all their shares to a single purchaser. The negotiations for the sale proceeded independently by the individual sellers, and defendant Verin managed to negotiate a five-year employment agreement between himself and the purchaser, in addition to his stock sale. When the plaintiff discovered the terms of defendant's employment agreement, he sued under rule 10b-5, claiming that Verin had failed to disclose that he was receiving a premium for his shares. Following the most widely cited case upholding the sale of business doctrine, *Frederiksen v. Poloway*, the court concluded that the purchaser could not sue either of the sellers under federal securities law because the sale of business doctrine held that no security was acquired. Therefore, the inactive shareholder was prevented by the same reasoning from suing the other seller who was the active party in the business.

The flaw in the reasoning of *Barsy* is apparent if one hypothesizes that the company was publicly held and that the purchaser made a tender offer for all of its shares. It is clear that such a transaction would involve a security, at least as to the sellers, and probably as to the buyer as well. Nevertheless, at the close corporation level, the sale of business doctrine either requires the *Barsy* result or introduces an asymmetry that does not comport with the statutory structure, which distinguishes between securities and transactions in securities. Supporters of the sale of business doctrine will probably opt for the latter and hold that *Barsy* should have been permitted to sue, but it remains to be seen whether courts will accept the resulting asymmetry.

The similarity of the facts of *Barsy* and *Kardon* and the fact that *Barsy* may have been wrongly decided even under the sale of business doctrine do not mean that the court in *Kardon* was necessarily correct. The problem, however, is not simply one of admitting or rectifying a perceived asymmetry in these transactions but rather of determining as a policy matter the appropriate scope of the federal antifraud rules. The sale of business doctrine does not address that problem in any fundamental way and by creating a transactional asymmetry without any clear public policy basis, the doctrine leads courts, like the court in *Barsy*, into superficial reasoning and possibly incorrect results.

**D. Recent Supreme Court Learning**

*Marine Bank v. Weaver* is the most recent Supreme Court case concerning the definition of a security. Courts in only two sale of busi-

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82. 508 F. Supp. at 958.
84. 102 S. Ct. 1220 (1982).
ness cases have had the opportunity to incorporate the reasoning of *Marine Bank* into their analyses, and they come to opposite conclusions concerning its import for the sale of business doctrine. Although *Marine Bank* does not directly raise issues concerning the doctrine, as with all Supreme Court cases, the language of the opinion is likely to have ramifications beyond the particular facts involved and seems to have particular significance for the sale of business cases.

In *Marine Bank*, the plaintiffs purchased a certificate of deposit from the defendant bank and pledged it back to the bank to guarantee a loan by the bank to a third party meat company. The consideration for the guarantee was the meat company’s agreement to pay plaintiffs $100 per month plus fifty percent of the company’s net profits while the guarantee was in effect. Plaintiffs also had the right to use the company’s barn and pastures and to veto future borrowing by the company. The meat company later went bankrupt, and the bank indicated that it intended to claim the pledged certificate of deposit. Plaintiffs sued under section 10(b) of the 1934 Act, alleging that the bank actively solicited the guarantee without disclosing the bank’s knowledge concerning the financial plight of the meat company. The Third Circuit had reversed the trial court’s grant of summary judgment to the defendant bank on the ground that the trier of fact could reasonably have concluded that either the certificate of deposit itself or the profit-sharing agreement between plaintiffs and the meat company was a security.

The Court in *Marine Bank* began its analysis with a restatement of the general broad coverage of the definition of a security and, citing *Howey*, concluded explicitly that the definition “includes ordinary stocks and bonds, along with the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” For courts that rely on isolated Supreme Court dicta, this sentence might mean instant death for the sale of business doctrine; nothing in the *Marine Bank* opinion indicates that the Court meant anything other than exactly what it said with respect to “ordinary stocks and bonds.” Moreover, the Court went on to emphasize the broader coverage of the antifraud provisions, stating that they are not limited to shares of publicly held companies but extend to “uncommon and irregular instruments.”

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85. Sutter v. Groen, 14 SEC. REG. & L. REP. (BNA) 1557 (7th Cir. 1982); Golden v. Garafalo, 678 F.2d 1139, 1143-44 (2d Cir. 1982).
86. Like federal income taxation, securities law is a field so “beset with invisible boomerangs” that the Supreme Court might well be advised to withhold exercise of its “sporadic omnipotence.” See Arrowsmith v. Commissioner, 344 U.S. 6, 12 (1952) (Jackson, J., dissenting). That argument, however, is left to another day.
88. 102 S. Ct. at 1223.
89. See supra note 44.
90. 102 S. Ct. at 1223.
unequivocal indication that the Court intended to stop the ongoing development of the sale of business doctrine.

*Marine Bank* contains, in fact, both good and bad portents for the sale of business doctrine. The Court first analyzed whether the certificate of deposit issued by the defendant bank constituted a security. Because a bank certificate of deposit is not expressly listed in the definitional catalogue, the Court considered whether the certificate was functionally equivalent to any of the items in the catalogue or to anything the Court had previously held to constitute a security. The Third Circuit had determined that a security might be present because a certificate of deposit was different from any other long-term corporate debt obligation and was equivalent to the term “note” in the definitional list. However, the Supreme Court rejected this analysis because federal banking regulations virtually guaranteed that such a certificate would be paid in full, which distinguished the certificate from other long-term debt obligations. Moreover, the certificate was unlike the withdrawable capital share in a savings and loan association that had been held to be a security in an earlier case, *Tcherepnin v. Knight*, because the certificate of deposit paid a fixed rate of interest and did not provide voting rights. This analysis is not particularly surprising, but it bodes ill for the sale of business doctrine because the Court definitely did not follow the *Howey* analysis in determining whether the certificate of deposit was similar to a long-term debt security. The Court did not even employ *Howey* to determine whether the certificate was a security like that in *Tcherepnin*, which had been held to fall within the coverage of the term “investment contract.” Consequently, the application of the *Howey* test by the sale of business cases to the term “stock” in the definitional catalogue is arguably misplaced.

Next, the *Marine Bank* Court analyzed whether the agreement between plaintiffs and the meat company, which included a promise of fifty percent of the company’s profits, constituted either a “certificate of

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92. 102 S. Ct. at 1224-25.
94. 102 S. Ct. at 1224.
95. 389 U.S. at 338.
96. Speaking for the Seventh Circuit in the most recent sale of business case, Sutter v. Groen, 14 SEC. REG. & L. REP. (BNA) 1557 (7th Cir. 1982), Judge Posner reasoned that the Supreme Court’s approach to the term “note” in *Marine Bank* provided strong support for the sale of business doctrine, on the ground that the Court was taking the “unless the context otherwise requires” language seriously. Id. at 1558. That point, however, was already clearly established in *Forman* with express reference to the term “stock,” the meaning of which is the issue in the sale of business cases. Even accepting that both *Forman* and *Marine Bank* require consideration of “the economic as well as linguistic context,” id., it does not follow that the same economic test is to be applied to every item in the definitional catalogue. In particular, it does not follow that the *Howey* test, which is the analytical foundation of the sale of business cases, is to be applied across the board, because the Supreme Court in *Marine Bank* made no reference to *Howey* in determining that the certificate of deposit was not a “note.”
interest or participation in any profit-sharing agreement" or an "investment contract." Here the Court did purport to apply the Howey test, which reinforces the argument that Howey has application only to the catchall items in the definitional catalogue and not to the more traditional items like "stock" or "note." However, in what has to be considered a very surprising result, the Court concluded that the agreement was not an investment contract. If ordinary inferences may be drawn from the Court's approach, the Court has severely restricted the expansive view that has previously been taken with respect to this important catchall security. In this respect, the Marine Bank approach and the sale of business doctrine may be pointing at a common goal of removing from federal court disputes arising out of privately negotiated transactions.

Although the Supreme Court in Marine Bank purported to apply the Howey test to the profit-sharing agreement in question, the Court discussed at most only two of the four Howey elements and, apparently, severely limited their application. The Court first considered Howey's common enterprise requirement, noting that the interests that the Court had previously found to involve investment contracts had been essentially public offerings to a large number of potential investors. In contrast, the agreement in Marine Bank did not involve a common enterprise because it was privately negotiated and not designed to be publicly traded.97 This approach not only apparently wipes out "vertical commonality"98 as a basis for fulfilling the common enterprise element of Howey, but it also eliminates even horizontal commonality unless the interests are sufficiently numerous to be amenable to public trading. Although there is some isolated judicial authority for considering the number of purchasers in determining whether a security is present in the transaction,99 this approach is conceptually inconsistent

97. 102 S. Ct. at 1225.

98. Vertical commonality refers to a common interest in profits between the issuer of the purported security (for example, the broker issuing a discretionary commodities contract) and the purchaser. Horizontal commonality requires a pooling of funds of more than one investor, regardless of the interest of the purported issuer. There has been considerable debate on whether horizontal commonality is required to meet the common enterprise element of Howey or whether vertical commonality is sufficient. Compare Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977) with SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974). See, e.g., Seagrave Corp. v. Vista Resources, Inc., 534 F. Supp. 378, 384 (S.D.N.Y. 1982); SEC v. International Mining Exch., Inc., 515 F. Supp. 1062, 1067-68 (D. Colo. 1981); Troyer v. Karcagi, 476 F. Supp. 1142, 1147-48 n.7 (S.D.N.Y. 1979).

99. Courts in some of these cases have applied the "commercial/investment" distinction in determining whether a promissory note is a security. See supra text accompanying notes 56-61. In such a case the number of purchasers may be a contextual factor distinguishing a commercial loan from an investment. E.g., Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1258 (9th Cir. 1976); Lino v. City Investing Co., 487 F.2d 689, 694-95 (3d Cir. 1973); Robbins v. First Am. Bank, 514 F. Supp. 1183, 1188 (N.D. Ill. 1981). Other courts, however, have looked to this factor in determining whether, for example, a loan participation agreement was an investment contract. E.g., Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1182 (6th Cir.), cert. denied, 102 S. Ct. 972 (1981); Provident Nat'l Bank v. Frankford Trust Co., 468 F. Supp. 448, 455 (E.D. Pa. 1979).
with the statutory structure, which distinguishes between securities and
transactions in securities,\textsuperscript{100} therefore, most courts have not considered
this a factor. Consequently, \textit{Marine Bank} may represent a major
change in this area of law, especially if the Court’s approach is not
limited to investment contracts.\textsuperscript{101}

The second \textit{Howey} element the Court considered in \textit{Marine Bank}
was control over the enterprise. In one sentence the Court noted that
the right of the plaintiffs to veto future loans gave them a measure of
control.\textsuperscript{102} Again, the opinion is impressive for what it does not say. If
the Court intended veto power over loans to constitute enough control
to take the transaction out of the security classification, few privately
negotiated securities transactions may remain. Sophisticated investors
invariably demand some similar measure of control over major
to changes or activities of the enterprise, and even minority shareholders
in close corporations are best advised to insist on such veto powers if
they are to have any hope of protecting their investments from the
arbitrary will of the majority.\textsuperscript{103}

Therefore, \textit{Marine Bank} may go even a step further than the sale
of business cases in removing closely held enterprises and their investors
from regulation under federal securities law. On the other hand, the
opinion can be read as implicitly rejecting the sale of business
doctrine. Either conclusion, however, is premature.

If read narrowly, the Supreme Court decision in \textit{Marine Bank}
do not require dispensing with the sale of business doctrine any more
than \textit{Forman} compelled its adoption. \textit{Marine Bank} dealt with a bank
certificate of deposit that clearly was not “stock” within anybody’s defini-
tion of that term. Nevertheless, the \textit{Marine Bank} Court did say that
“ordinary stocks and bonds” are included within the federal definition
of a security.\textsuperscript{104} Moreover, the Court did not apply the \textit{Howey} test in
determining whether the certificate of deposit was a note and analyzed
only two of the elements of \textit{Howey} in determining whether the profit-
sharing agreement was an investment contract. Thus, the Court’s
approach in \textit{Marine Bank} provides little support for an argument that
\textit{Howey} applies across the board in the definitional catalogue in deter-
mining whether instruments are securities.\textsuperscript{105} Consequently, both the

\textsuperscript{100} See supra text accompanying notes 14-30.

\textsuperscript{101} The manner of sale, particularly the seller’s emphasis on investment virtues, can be an
important contextual factor in holding that an unusual scheme falls within the investment contract
No. 5347 (Jan. 4, 1973). Even in this limited area, however, no case has held the manner of sale to
be determinative.

\textsuperscript{102} 102 S. Ct. at 1225.

\textsuperscript{103} Karjala, \textit{A Second Look at Special Close Corporation Legislation}, 58 Tex. L. Rev. 1207,
1222-26 (1980).

\textsuperscript{104} Id. at 1223.

\textsuperscript{105} Judge Posner of the Seventh Circuit takes the view that \textit{Marine Bank} supports the sale of
business doctrine, but his reasoning is of questionable validity. See supra note 96.
express language and the analytical approach of Marine Bank run strongly against the trend toward the adoption of the sale of business doctrine.

In indicating, moreover, that the "investment contract" label is intended essentially for investment opportunities that are offered in more or less identical form to a large number of persons, the Marine Bank opinion severely restricts the operative reach of that term. If the assumption underlying the sale of business doctrine—that the investment contract definition applies across the board—is upheld, the result will be that no privately negotiated transaction will fall within the scope of federal securities regulation. In view of the private offering exemption under the 1933 Act, this result seems almost preposterous. One can only assume, therefore, that the interpretation of the various items in the definitional catalogue will proceed along at least partially independent lines, as the interpretation of the terms "investment contract" and "note" has proceeded in the past.

This need not, of itself, spell the doom of the sale of business doctrine. Notwithstanding its shaky analytical foundations, the doctrine may well have acquired a life independent of Howey and the investment contract cases.106 This result could perhaps even be applauded if there were a significant policy basis for an interpretation of the term "stock" that depended on the nature of the transaction rather than simply on the terms of the instrument itself. As argued below, however, no such basis exists in federal securities regulation policy, and the sale of business doctrine should either be abandoned or overruled by statutory or rule amendment. The doctrine simply does not reach what may well be the real lesson of Marine Bank, which is that federal securities law, including the antifraud provisions, should not trench too deeply into state jurisdiction over the affairs of closely held businesses.

106. Indeed, this seems to be the approach of the Seventh Circuit in the recent case of Sutter v. Groen, 14 SEC. REG. & L. REP. (BNA) 1557 (7th Cir. 1982). Judge Posner in Sutter cited the seminal sale of business case, Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981), which relied almost solely on an application of the Howey test to the stock transaction in question, as precedential authority but included none of the Poloway analysis in his opinion. Instead, he relied on the recent Supreme Court opinion in Marine Bank (arguably incorrectly, see supra note 96), and then went on to argue that the legislative history of the 1934 Act shows a congressional intent to protect "investors" as opposed to "entrepreneurs." 14 SEC. REG. & L. REP. (BNA) at 1558. His analysis, unfortunately, refers only to congressional concern with fraud and speculation in the national securities markets. This may well have been in the forefront of the minds of most members of Congress when the statutes were adopted, but the evidently intentionally broad reach of the antifraud provisions of both the 1933 and 1934 Acts, see supra text accompanying notes 14-30 and text accompanying note 71, shows that Congress could not have intended the statutes to apply solely to participants in those markets. Nevertheless, his "investor/entrepreneur" distinction for determining what types of "stock" constitute securities may develop along lines similar to the "investment/commercial" distinction that has long been used in determining what kinds of "notes" constitute securities. See supra text accompanying notes 56-62. It should be observed incidentally, however, that the "investor/entrepreneur" distinction is wholly useless in a case like Forman, which is the one Supreme Court decision dealing with the meaning of "stock" in the definitional catalogue. The holders of the certificates in Forman were undoubtedly not investors; they are just as surely not classifiable as entrepreneurs, either.
IV. REALIGNING FEDERAL AND STATE ROLES UNDER THE SALE OF BUSINESS DOCTRINE

Some commentators have argued for removing rule 10b-5 and the other federal antifraud provisions from a regulatory role in the affairs of closely held companies.107 Insofar as one views the purpose of federal securities regulation as preventing abuses in and protecting the integrity of the national securities markets, this goal is probably legitimate.108 One must bear in mind, however, that the antifraud provisions of both the 1933 and the 1934 Acts are intentionally broader than the registration and public disclosure provisions,109 and any interpretation excluding closely held corporations from the reach of the antifraud provisions should have some basis that is not easily found in the statutes as presently written. The sale of business doctrine is not well suited to this task. By relying on the definition of a security rather than on the operative reach of the regulatory provisions, the doctrine does not completely achieve the goal of removing closely held corporations from federal securities regulation. Moreover, the doctrine brings with it serious side effects.

If, for example, future cases follow Barsy and reject the asymmetry that is implicit in the sale of business doctrine, the determination of whether a seller of a minority interest has a federal securities claim will depend on whether a transfer of control accompanied his sale. Because by hypothesis the minority shareholder is dependent on those in control of the corporation for his expectation of profit, it seems absurd to give him a claim against his purchaser or against the majority shareholder for fraud when the minority shareholder alone has transferred his interest but not when the majority shareholder has done so as well. The latter situation provides much more opportunity for exploitation of the inactive party's position than does the former. Conversely, if the asymmetry resulting from the sale of business doctrine is accepted, minority shareholders' transactions, which economically are the least important, will remain covered by federal law, while the more important transfers of control will lie outside federal regulation. There is little force in the argument that the purpose of federal securities law is to protect only passive investors. Neither the language of the statutes nor

107. See supra note 7.

108. Outside the specific context of the sale of business doctrine, a few courts have indicated misgivings about applying the federal securities laws, especially the 1934 Act, to closely held enterprises. E.g., Glick v. Campagna, 613 F.2d 31, 35 n.3 (3d Cir. 1979); Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 496 F.2d 1255, 1262 n.3 (4th Cir.), cert. denied, 419 U.S. 1023 (1974); Chiodo v. General Waterworks Corp., 380 F.2d 860, 864 (10th Cir. 1967); Braniff Airways, Inc. v. LTV Corp., 479 F. Supp. 1279, 1283, 1288 (N.D. Tex. 1979) (indicating the particular concern for federalism that may underlie the sale of business doctrine); see also Golden v. Garafalo, 678 F.2d 1139, 1147 (2d Cir. 1982) (Lumbard, J., dissenting) (arguing that persons who negotiate private deals do not need federal securities law protection).

the legislative history provides a basis for concluding that the Acts protect small investors and not large ones. 110 In the case of publicly held corporations, in fact, transfers of control are of such significance that they have been made the subject of specific regulatory legislation. 111

Moreover, the results under the sale of business doctrine do not completely remove federal securities law from involvement in the affairs of close corporations and their shareholders. Holders of preferred stock, many long-term debt instruments issued by close corporations, and minority common shareholders will still have recourse in federal law. In addition, federal law will continue to apply to transactions in shares of closely held corporations in which there is no single majority shareholder. It is difficult to see how national policy requires such distinctions in applying antifraud regulations.

It is impossible to argue that the courts have never made a wrong turn or incorrect decision under the securities laws, but, especially in an area this complicated, there is much to be said for sticking even to incorrect decisions and permitting rectification to come only from Congress. Securities law affects thousands of transactions every day, and parties often negotiate their deals and choose the forms in which they effect their transactions with knowledge of the law, even as interpreted by the judiciary. 112 The difficulties posed by unclear and unpredictable rules and case law need not be elaborated. 113 The advantages of predictive and objective rules are recognized by the SEC and have led to the adoption of numerous “safe harbor” provisions in SEC rules. 114

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110. Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 496 F.2d 1255, 1263 (4th Cir.), cert. denied, 419 U.S. 1023 (1974). The partnership and joint venture cases look also to legal rights of participation rather than to actual participation in the affairs of the enterprise in determining whether a security is present. See supra text accompanying notes 75-76. If passive investments were the subject of the regulatory concern, the latter would presumably be more relevant than the former.

111. 1934 Act §§ 13(d) & 14(d), 15 U.S.C. §§ 78m(d), 78n(d) (1976).

112. United Housing Founds., Inc. v. Forman, 421 U.S. 837, 850-51 (1975); Coffin v. Polishing Machs., Inc., 596 F.2d 1202, 1292 (4th Cir.), cert. denied, 444 U.S. 868 (1979); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 336 (W.D. Pa. 1980); Bronstein v. Bronstein, 407 F. Supp. 925, 929 (E.D. Pa. 1976). Two cases upholding the sale of business doctrine have attempted to refute the expectations of the parties argument on the ground that either the parties in the particular case knew that they were really involved in an assets rather than a stock transaction, Golden v. Garafalo, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), rev’d, 678 F.2d 1139 (2d Cir. 1982), or that subjective intentions and expectations cannot be determinants of federal law, Seagrate Corp. v. Vista Resources, Inc., 534 F. Supp. 378, 383 (S.D.N.Y. 1982). Both arguments are fallacious. The important issue is not whether the parties understand the economic reality of their particular transaction, but whether they know which law applies to the transaction. Moreover, expectations should be at least a partial determinant of the law when those expectations have been generated by a decades-long application of a given set of rules to a particular transaction.

113. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953), which was a most troublesome decision because of the difficulty it caused in determining a priori when the private offering exemption under the 1933 Act was going to be available. On the advantages of certainty in the specific context of the definition of a security, see Dillport, supra note 26, at 119-20.

114. Former rule 146, now Regulation D, under the 1933 Act, 17 C.F.R. 230.501-230.506, constitutes the SEC’s more objective response to the Ralston Purina problem, supra note 112.
This hardly seems the time to reopen all these questions through the jurisdictional definition of a security.

Moreover, if the court in Kardon v. National Gypsum Co.\textsuperscript{115} was wrong in extending the reach of rule 10b-5 to transactions in the stock of closely held corporations, applying Howey's investment contract analysis to every item in the securities definitional catalogue is not the appropriate remedy. Courts are simply not very well equipped to establish the detailed distinctions that are necessary in objective tests for the application of the various operative provisions of the securities laws. Rather, it seems best to rely on Congress or the SEC to narrow the scope of the antifraud rules, if that comports with more modern views of the proper roles of federal and state law in the securities area.

Finally, the attempt to remove closely held businesses from the purview of federal securities regulation through reliance on the definition of a security is unlikely in any event to result in an effective role for state securities regulation in this area. The problem is inherent in our long tradition of distinguishing securities from transactions in securities. State securities laws embody almost universally this same distinction, and the vast majority of these statutes defines the term “security” in language very similar to that used in the federal statutes. Most states thus have a definitional catalogue identical or very similar to that of the federal statutes and include in the list such items as “stock,” “note,” and “investment contract.”\textsuperscript{116} In addition, when interpreting these common terms under state law, many states follow federal court interpretations of federal law.\textsuperscript{117} This approach is commendable because it leads to uniformity in the interpretation of technical statutes. Nevertheless, this generally salutory method of statutory interpretation may have backfired with the sale of business doctrine. If the purpose of the federal cases adopting the sale of business doctrine has been to realign federal and state roles in the regulation of the affairs of closely held businesses, that policy basis has never emerged in the opinions of the courts.\textsuperscript{118} Rather, courts have followed what purports to be simply a reading of the express terms of the definitional statute. Given the pervasive federal influence in this area and the hidden nature of the apparent policy underlying the trend, it is not surprising to see courts interpreting even state law concerning the definition of a security in the


\textsuperscript{116} The Uniform Securities Act has been adopted in over 30 states, for example, and for purposes of the sale of business doctrine, its language may be considered identical to the federal definition. Uniform Securities Act § 401.


\textsuperscript{118} Judge Posner, in Sutter v. Groen, 14 Sec. Reg. & L. Rep. (BNA) 1557, 1559 (7th Cir. 1982) comes perhaps closest to articulating this goal in arguing against expanding liability, presumably federal liability, as a general goal. He does not, however, discuss the effects of federal retrenchment upon state law.
same way that the federal courts have under the sale of business doctrine. Several courts interpreting state law have done exactly this and dismissed state securities law claims on the ground that no security was involved.\textsuperscript{119}

The result is to throw back into the realm of common law fraud an entire range of cases involving the transfer of control of closely held business enterprises. Few of even the most ardent supporters of a strengthened role for state law in the field of corporate governance and corporate transactions have argued that a return to the substance of common law fraud in transactions in the shares of closely held corporations would be a step forward.\textsuperscript{120} Because most states have a state law equivalent of rule 10b-5,\textsuperscript{121} the substantive law relating to these transactions under state law probably would include many of the significant advances that federal law has heretofore provided in the form of lower barriers to plaintiffs seeking relief from fraudulent and manipulative securities transactions. If, however, courts dismiss such cases based on the definition of a security, many of these advances will be lost, and plaintiffs will have to go through another long period of educating courts to the need for a more flexible approach to fraudulent activity than the common law has heretofore provided.

V. Conclusion

Courts that base their decisions on "economic realities" in holding that shares of common stock in profit-making corporations do not constitute "stock" within the meaning of the federal securities statutes misinterpret the congressional intent evidenced in the statutory structure. The results are without logical foundation either in the language of the statutes themselves or in the Supreme Court holdings on which the cases purport to rely. If the purpose of the trend, although still unstated, is to remove closely held corporations from regulation under federal securities law, that goal has not been achieved in a significant number of cases. In other cases, identical reasoning would preclude federal regulation even where several hundred shareholders might be


\textsuperscript{120} One commentator, in fact, rests much of his argument for rescinding rule 10b-5's jurisdiction over close corporations on the strengthened protections that state law now gives to participants in closely held business. Note, supra note 7, at 750-59.

\textsuperscript{121} Section 101 of the Uniform Securities Act, for example, is virtually identical to rule 10b-5. Uniform Securities Act § 101 (1956).
involved. The cases introduce into the analysis an asymmetry that is discomfiting at best and almost certain to introduce significant procedural complications as the case law develops. The uncertainties involved in the sale of business doctrine make planning of transactions in stock of closely held businesses more complicated, and therefore more costly. In addition, the sale of business doctrine seems unlikely to achieve an appropriate balance of state and federal regulation in the securities area. Rather, this doctrine is likely to result in the exclusion of transfers of control of close corporations from the procedural and substantive advances in antifraud protection that have developed under both federal and state securities laws.

Moreover, an alternative means of realigning federal and state securities roles exists in administrative or statutory rulemaking. Because most transactions in securities of closely held corporations are exempt from the registration, prospectus, and public information requirements of federal law, the only area in which the issue arises in practice is in antifraud claims, primarily under rule 10b-5. The validity of rule 10b-5 has been upheld by the Supreme Court, and it seems clear that the SEC has discretionary power to restrict the rule's application to certain classes of business enterprises. So far, neither Congress nor the SEC has so limited rule 10b-5. If this attitude in the legislature and the administrative agency responsible for the enforcement of the securities laws continues, it is inappropriate for the courts to effect the drastic changes implied by the adoption of the sale of business doctrine. On the other hand, even if the courts are correct that federal regulation in this area needs to be curtailed, it is more appropriate to rely on Congress or its designated administrative agency to effect the many technical changes that are necessary, leaving the courts in their traditional role of interpreting in the interstices of the statutes.

If, however, the trend has already achieved a momentum that cannot be judicially reversed, as appears possible, it seems advisable for Congress to act by amending the statutes. This amendment should take the form of an express provision that stock in ordinary profit-making corporations is included within the definition of a security. If it is desirable to restrict the federal role in regulating the affairs of closely held enterprises, Congress should, in a separate provision, make the antifraud rules inapplicable only to transactions in shares of statutorily defined close corporations.

122. Ratner, supra note 7, at 951-52.
123. Until Judge Winter's recent opinion in Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982), the trend toward adoption of the sale of business doctrine seemed almost irreversible. One may now hope that the courts will begin moving in the opposite direction without congressional or administrative prodding. But see Sutter v. Groen, 14 SEC. REG. & L. REP. (BNA) 1557 (7th Cir. 1982) (rejecting the reasoning of Judge Winter in Garafalo).