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The Sale of Business Doctrine: Judicial Exemption from the Federal Securities Laws

THE SALE OF BUSINESS DOCTRINE: JUDICIAL EXEMPTION FROM THE FEDERAL SECURITIES LAWS

Congress enacted the Securities Act of 1933 ('33 Act)[1] and the Securities Exchange Act of 1934 ('34 Act)[2] to regulate the purchase and sale of securities.[3] The '33 and '34 Acts define the term "security" to include any stock, bond, note, debenture, investment contract, certificate of interest, or participation in a profit-sharing agreement, or any instrument commonly known as a "security."[4] Whether particular instruments are securities under the federal securities laws, however, remains the subject of judicial debate.[5] Some courts have exempted sales of a controlling interest in the ordinary corporate stock of a business from the requirements of the '33 and '34 Acts.[6] The sale of

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1. *The Securities Act of* 1933 ('33 Act), 15 U.S.C. §§ 77a-77bbbb (1982).

2. *The Securities Exchange Act of* 1934 ('34 Act), 15 U.S.C. §§ 78a-78kk (1982).

3. *See* 15 U.S.C. § 78b (1982) (purpose of '34 Act to regulate exchanges and over-the-counter markets when securities are traded on large scale); Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982) (purpose of securities acts is investor protection). Courts that accept the sale of business doctrine maintain that Congress enacted the securities laws to protect persons who transfer their investments to third parties, not to protect persons who manage their investments themselves. *See* 77 CONG. REC. 937 (1933) (President Roosevelt's proposal to Senate for federal regulation of investment securities). In President Roosevelt's message to the Senate proposing federal regulation of securities issues, Roosevelt argued for a return to a clearer understanding that persons who handle or use other persons' money are trustees acting for others. *Id.; see* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (purpose of '33 Act is to protect investors); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 26 (10th Cir. 1972) (purpose of § 17(a) of '33 Act and SEC rule 10b-5 is protection of investors); Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371, 1376 (W.D.N.Y. 1969) (purpose of § 12(2) of '33 Act is investor protection); *see also* S. REP. No. 792, 73d Cong., 2d Sess. 5 (1934) (purpose of '34 Act is to prevent excessive use of credit for speculation, unfair practices employed in speculation, and secrecy surrounding financial condition of corporations which invite public to purchase securities); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933) ('33 Act requires seller make full disclosure); Shulman, *Civil Liability and the Securities Act*, 42 YALE L.J. 227, 27 (1933) (same).

4. *Compare* 15 U.S.C. § 77b(1) (1982) (defining term "security") *with* 15 U.S.C. § 78(c)(a)(10) (1982) (defining term "security"). *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975) (definition of "security" in '34 Act substantially same as in '33 Act).

5. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (federally guaranteed and insured bank certificate of deposit not security); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 570 (1979) (noncontributory, compulsory pension plan not security); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849-50 (1975) (shares in cooperative housing not securities despite denomination as "stock"); *cf.* Tcherepin v. Knight, 389 U.S. 332, 335-46 (1967) (withdrawable capital share in savings and loan constitutes security); SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 212 (1967) ("Flexible Fund" annuities constituted securities); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 66-73 (1959) (variable annuities constituted securities); SEC v. W. J. Howey Co., 328 U.S. 293, 294, 301 (1946) (interests in citrus grove constituted securities); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (interests in oil and gas leases constituted securities).

6. *See* Sutter v. Groen, 687 F.2d 197, 199 (7th Cir. 1982) (sale of entire business to single

business doctrine provides that the transfer of a controlling interest in the stock of a corporation to a purchaser who intends to manage or direct the management of the business does not constitute a sale of securities within the meaning of the federal securities laws.[7] Courts accepting the sale of business doctrine focus on the analysis of the Supreme Court in *SEC v. W.J. Howey Co.*[8] In *Howey*, the Court considered the application of Section 2(1) of the

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purchaser is not "security" transaction under federal securities laws even if accomplished by sale of stock or other securities); King v. Winkler, 673 F.2d 342, 343 (11th Cir. 1982) (sale of 100% of corporate stock to purchasers who intend to manage business is not security transaction governed by federal securities laws); Canfield v. Rapp & Son, Inc., 654 F.2d 459, 464-65 (7th Cir. 1981) (recognizing Seventh Circuit's acceptance of sale of business doctrine in *Fredriksen*); Frederiksen v. Poloway, 637 F.2d 1147, 1154 (7th Cir.) (purchase of 100% of stock in marina did not involve "security" within meaning of federal securities laws), *cert. denied*, 451 U.S. 1017 (1981); Chandler v. Kew, Inc., 691 F.2d 443, 444 (10th Cir. 1977) (purchase of 100% of stock of liquor store holding company as indicia of ownership of store, not "security transaction" within meaning of securities acts); Kane v. Fischbach, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,608, at 92,988-89 (E.D.N.Y. March 31, 1982) (sale of company stock to controlling partners of partnership which included seller was not transaction subject to federal securities laws); Reprosystem, B.V. v. SCM Corp., 522 F. Supp. 1257, 1274 (S.D.N.Y. 1981) (federal securities laws inapplicable to stock transfer because purchaser intended to manage and operate business without expectation of profits from efforts of others); Anchor-Darling Indus., Inc. v. Suozzo, 510 F. Supp. 659, 666 (E.D. Pa. 1981) (purchase of controlling stock of three closely held corporations not "security transaction" as contemplated by federal securities laws)]; Zilker v. Klein, 510 F. Supp. 1070, 1075 (N.D. Ill. 1981) (purchase of all stock of corporation amounted to assumption of control so that no securities involved for purpose of rule 10b-5).

7. *See supra* note 6 (cases sanctioning sale of business doctrine). A number of commentators have discussed the sale of business doctrine. *Compare* Prentice & Roszkowski, *The Sale of Business Doctrine: New Relief From Securities Regulation or a New Haven for Welshers?*, 44 OHIO ST. L.J. 473, 520 (1983) (recommending rejection of sale of business doctrine based on Supreme Court precedent, statutory construction, and policy grounds) *and* Comment, *A Criticism of the Sale of Business Doctrine*, 71 CALIF. L. REV. 474, 985 (1983) (arguing for rejection of sale of business doctrine because '33 and '34 Acts specifically define security to include stock, sale of business cases provide inadequate reasons for departing from definition's specific terms, and application of doctrine would engender considerable administrative difficulties) [hereinafter cited as *Criticism*] *and* Note, *Repudiating the Sale-of-Business Doctrine*, 83 COLUM. L. REV. 1718, 1719, 1732 (1983) (arguing against acceptance of sale of business doctrine because doctrine confuses definition of "investment contract" with definition of "stock" and thereby denies protection of '33 and '34 Acts to investors who need Acts' protection) [hereinafter cited as *Repudiating*] *with* Easley, *Recent Developments in the Sale-of-Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 BUS. LAW 929, 975-76 (1984) (sale of business doctrine supported theoretically and by Supreme Court precedent) *and* McAneny, *Acquisition of Businesses Through Purchases of Corporate Stock: An Argument For Exclusion From Federal Securities Regulation*, 8 FLA. ST. U. L. REV. 295, 317 (1980) (arguing that investment contract formula should apply to exclude from federal regulation all transactions involving stock transfer that is merely incidental to acquisition of business)] *and* Sedlin, *When Stock is Not a Security: The "Sale of Business Doctrine" Under the Federal Securities Laws*, 37 BUS. LAW 637, 680-81 (1982) (recommending acceptance of sale of business doctrine) *and* Thompson *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225, 236-52 (1982) (concluding that sale of 100% of stock of business is not security transaction).

8. 328 U.S. 293 (1946).

'33 Act[9] which defines "security" to include any "investment contract"[10] to an offering of units in a citrus grove combined with a service contract for cultivating, marketing, and remitting the net proceeds to the investor.[11] The Securities and Exchange Commission (SEC) brought an action to restrain the offeror from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and nonexempt securities in violation of section 5(a) of the '33 Act.[12] In determining whether the transaction was an investment contract within the meaning of section 2(1), the Supreme Court developed a three-part test.[13] The Court defined an investment contract as a contract, transaction or scheme in which a person invests money in a common enterprise with an expectation of profits solely from the efforts of another party.[14] Applying the test to the transactions in *Howey*, the Court found that the investors provided capital and shared in the earnings and profits while the promoters managed, controlled, and operated the enterprise.[15] The Court concluded that the transactions were investment contracts, and therefore the promoters had violated the '33 Act by failing to register the securities.[16]

The *Howey* test brought a number of instruments not specifically listed in the '33 and '34 Acts' definitions of a security under the term investment contract.[17] In *United Housing Foundation, Inc. v. Forman*,[18] the Supreme Court applied the *Howey* test to an instrument labelled "stock."[19] The Court

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9. 15 U.S.C. § 77b(1) (1982).

10. *See id.; see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (defining "investment contract" as investment in common venture with expectation of profits from others' efforts).

11. 328 U.S. at 294.

12. *Id.* Section 5(a) of the '33 Act prohibits the use of the mails or any means or instruments of transportation or communication in interstate commerce to sell securities unless the offeror files a registration statement with the Securities and Exchange Commission (SEC). 15 U.S.C. § 77e(a) (1982).

13. *See* 328 U.S. at 298-99 (development of *Howey* economic realities test).

14. *Id.*

15. *Id.* at 299-301. The *Howey* Court concluded that the land sales contracts, warranty deeds and service contracts in issue were investment contracts because investors contributed money and shared in the profits of an enterprise managed and partly owned by third parties. *Id.* at 299-300.

16. *Id.* at 300.

17. *See* Smith v. Gross, 604 F.2d 639, 642-43 (9th Cir. 1979) (animal breeding program was investment contract subject to securities laws); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 484-86 (5th Cir. 1974) (pyramid cosmetics selling scheme was investment contract for purposes of securities laws); SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482-83 (9th Cir.) (self-improvement courses were securities within meaning of federal securities laws), *cert. denied*, 414 U.S. 821 (1973); SEC v. Glen-Arden Commodities, Inc., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,142, at 94,605 (E.D.N.Y. 1973) (warehouse receipts constituted securities in form of investment contracts); Riviera Operating Co., 1978 SEC. REG. L. REP. (BNA) No. 449, § C, at 1 (SEC No-Action Letter Apr. 19, 1978) (memberships in recreational facilities were securities).

18. 421 U.S. 837 (1975).

19. *Id.* at 851-58. The "stock" considered in *Forman* amounted to a recoverable deposit on an apartment. *Id.* at 842. The sole purpose of purchasing the shares of stock was to entitle

in *Forman* decided whether common stock in a nonprofit cooperative housing corporation constituted securities within the purview of the '33 and '34 Acts.[20] The plaintiffs in *Forman* alleged violations of the antifraud provisions of the '33 and '34 Acts[21] in the sale of the stock.[22] In *Forman*, prospective residents of a state subsidized apartment complex bought shares of stock in the nonprofit housing corporation as a prerequisite to acquiring subsidized low cost living space from the corporation.[23] Upon examining the transactions, the Supreme Court concluded that the housing stock was not a security under the federal securities laws.[24] The Court held that although the housing corporation called the shares "stock," Congress intended the application of the securities laws to depend on the economic realities underlying a transaction and not on the name given to an instrument.[25] Rejecting a literal approach which regards any instrument termed "stock" as a security, the Court held that the housing stock was in substance not a security for the purposes of the federal securities laws because the housing stock did not possess any characteristics traditionally associated with stock.[26]

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the buyer to occupy an apartment in Co-op City, a low cost housing cooperative. *Id.* The housing shares could not be transferred to a nontenant, could not be pledged or encumbered, and descended only to a surviving spouse. *Id.* In addition, the shares did not entitle the holder to voting rights in proportion to the number of shares purchased. *Id.* Each apartment had one vote irrespective of the number of shares owned. *Id.* The housing cooperative required any tenant wishing to terminate his occupancy to resell the stock to the corporation at cost. *Id.*

20. *Id.* at 842-43; *see supra* note 1 ('33 Act); *supra* note 2 ('34 Act).

21. 421 U.S. at 844-45. The plaintiffs in *Forman* alleged that the defendants falsely represented and failed to disclose several material facts in the housing cooperative's information bulletin. *Id.* at 844. In *Forman*, the plaintiffs asserted claims under § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1982), § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1983).

22. 421 U.S. at 844-45.

23. *Id.* at 842-43. The residents in *Forman* acquired apartments in the housing cooperative by purchasing 18 shares of stock in Riverbay Corporation (Riverbay) for each room in the apartment. *Id.* at 842.

24. *Id.* at 847-58.

25. *Id.* at 849. The *Forman* Court held that courts should value substance over form when defining the term "security." *Id.* at 848. The Court concluded that because securities transactions are economic in character, whether a transaction is a security depends on the economic realities of the transaction. *Id.* at 849. The *Forman* Court concluded that Congress intended the federal securities laws to apply to transactions which are securities in fact, not only in name. *Id.*

26. *Id.* at 848-51. The *Forman* Court noted that every circuit court with the exception of the Second Circuit had rejected a literal approach to the definition of a security. *Id.* at 849 n.14. The *Forman* Court dismissed as dicta any support for a literal approach contained in *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). *Id.* at 849-50. In dictum, *Joiner* noted that instruments may be included within the definition of a security as a matter of law, if the instruments answer to one of the terms listed in the statutory definition. *See* 320 U.S. at 351. The *Forman* Court, however, concluded that the dicta in *Joiner* did not establish an inflexible rule barring inquiry into the economic realities of a transaction. *See* 421 U.S. at 850. The *Forman* Court found that the housing "stock" did not possess any attributes ordinarily associated with stock. *Id.* at 851. For example, the shares were not negotiable, could not be pledged or hypothecated, conferred no voting rights in proportion to the number of shares owned, could not appreciate in value, and did not provide the right to receive dividends contingent upon an apportionment

Addressing the issue of whether the housing stock constituted an investment contract under the '33 and '34 Acts, the Supreme Court again examined the substance of the transaction by applying the *Howey* test.[27] The *Forman* court stated that an investment contract was an investment in a common venture premised on a reasonable expectation of profits from the entrepreneurial or managerial efforts of others.[28] Because the plaintiffs' motivation in purchasing housing stock was to acquire living quarters for personal use and not to invest for profit, the stock did not constitute a security.[29]

The *Forman* decision limited the definition of a security by holding that an instrument called "stock," a term specifically listed in the '33 and '34 Acts' definition of a security, was not necessarily a security transaction.[30] In *Marine Bank v. Weaver*,[31] the Supreme Court again held that another specifically listed instrument, a bank certificate of deposit, was not necessarily a security.[32] In *Weaver*, the plaintiffs purchased a certificate of deposit from the Marine Bank.[33] The plaintiffs pledged the certificate of deposit to Marine Bank to guarantee a loan to a company that owed money to the bank and was also overdrawn on its checking account.[34] In consideration for guaranteeing the loan, the company promised the plaintiffs a share of the company's profits.[35] Although the plaintiffs requested that the company invest the new loan as working capital, the company used the loan to pay overdue debts to the bank.[36] The company subsequently went bankrupt and the bank claimed the pledged

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of profits. *Id.* The *Forman* Court determined that the purchasers bought the housing shares solely to acquire low cost housing and not for investment purposes. *Id.*

27. *See* 421 U.S. at 852. The *Forman* Court found no distinction between an "investment contract" and an "instrument commonly known as a security." *Id.* The Court, therefore, constructed a single test for determining whether a transaction is a security. *See id.* The Court maintained that the *Howey* economic realities test for determining an investment contract embodies the essential attributes running through all of the Supreme Court's decisions defining a security. *Id.*

28. *Id.* The *Forman* Court explained that the securities laws did not apply when the purchaser desires to use or consume the item purchased. *Id.* at 852-53. The plaintiffs in *Forman* purchased a place to live, and therefore the securities laws did not cover the "stock" transactions. *Id.* at 853.

29. *See id.* at 853, 858 (securities laws do not apply when person purchases commodity for personal consumption or living quarters for personal use).

30. *See id.* at 847-58.

31. 455 U.S. 551 (1982).

32. *See id.* at 559.

33. *Id.* at 552.

34. *Id.* at 553. The plaintiffs in *Weaver* pledged a $50,000 certificate of deposit to Marine Bank to guarantee a $65,000 loan made by the bank to Columbus Packing Company (Columbus). *Id.* at 552-53. Columbus was a wholesale slaughterhouse and retail meat market which owed Marine bank $33,000 for prior loans. *Id.* at 553.

35. *Id.* In *Weaver*, under the terms of the agreement with Columbus, the plaintiffs would receive 50% of the company's net profits and $100 per month as long as the plaintiffs guaranteed the $65,000 loan. *Id.*

36. *Id.* The plaintiffs in *Weaver* alleged that Marine Bank officers told the plaintiffs that Columbus would use the $65,000 loan as working capital. *Id.* Instead, Columbus used the proceeds to pay overdue debt obligations to Marine Bank. *Id.*

certificate of deposit.[37] Asserting that the certificate of deposit was a security as defined by the '34 Act, the plaintiffs brought suit alleging that the bank had violated the disclosure requirements of rule 10b-5 by misrepresenting the intended use of the guaranteed loan and by failing to disclose the company's poor financial condition.[38]

Reasoning that the federal banking laws provide adequate protection to persons who purchase certificates of deposit from federally regulated banks, the *Weaver* Court held that issuers of bank certificates of deposit are not subject to liability under the antifraud provisions of the federal securities laws.[39] In arriving at the conclusion that a bank certificate of deposit is not a security under the '33 and '34 Acts, the *Weaver* Court noted that an instrument which falls within the broad sweep of the '34 Act is not a security if the context otherwise requires.[40] One can interpret the *Weaver* decision as removing a specifically listed instrument from the literal definition of the securities laws because the regulatory structure of the banking industry provided a context that otherwise required exclusion of the bank certificate of deposit.[41] If the *Weaver* decision demonstrates a desire to narrow the scope of the federal securities laws, the Supreme Court's approach is consistent with the philosophy underlying the sale of business doctrine.[42]

Three circuits have adopted the sale of business doctrine, recognizing that purchasers who acquire one hundred percent of a corporation's stock with an intent to manage or direct the management of the business have not pur-

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37. *Id.* at 553-54.

38. *Id.* at 554. The plaintiffs in *Weaver* alleged that the Marine Bank violated § 10(b) of the '34 Act. *Id.; see* 15 U.S.C. § 78j(b) (1982) (prohibiting use of manipulative or deceptive device in connection with purchase or sale of any security). The plaintiffs also alleged violations of the Pennsylvania Blue Sky laws and common law fraud. 455 U.S. at 554.

39. *See* 455 U.S. at 558-59. The *Weaver* Court held that the bank certificate of deposit was not a security because the reserve, reporting, and inspection requirements of the federal banking laws protect the deposit. *Id.* at 558; *accord* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 570 (1979) (noncontributory, compulsory pension plan not security because regulated by ERISA).

In *Weaver*, the Court concluded that a bank certificate of deposit differed from other long-term debt obligations. *See* 455 U.S. at 558. For example, a holder of an ordinary long-term debt obligation assumes a risk of the borrower's insolvency but the Federal Deposit Insurance Corporation guarantees a purchaser of a bank certificate of deposit payment in full. *Id.* The federal banking laws provide holders of bank certificates of deposit with adequate protections. *Id.* at 559. Therefore, holders of bank certificates of deposit do not need the protection of the federal securities laws. *Id.* A bank certificate of deposit is not a security because the comprehensive set of regulations governing the banking industry provides a context which requires exclusion of the instrument from the coverage of the '33 and '34 Acts. *Id.* at 558-59; *see* 15 U.S.C. § 77b(1) (1982) (instrument not security if "context" otherwise requires); *id.* § 78(c)(a)(10) (1982) (same).

40. *See* 455 U.S. at 558-59.

41. *See id.*; Sutter v. Groen, 687 F.2d 197, 200-01 (7th Cir. 1982) (arguing that *Weaver* departed from literal terms of statutory definition of "security" since certificate of deposit is type of note); *see also Criticism, supra* note 7, at 984-85 (acknowledging *Sutter's* interpretation of *Weaver*).

42. *See Criticism, supra* note 7, at 981 (*Weaver* consistent with sale of business doctrine courts' narrowing scope of federal securities laws).

chased a "security" under the federal securities laws.[43] The Tenth Circuit adopted the sale of business doctrine in *Chandler v. Kew, Inc.*[44] In *Chandler*, the plaintiff contracted for the purchase of a liquor store through acquisition of one hundred percent of the outstanding stock.[45] The plaintiff contended that because the contract was for "stock," the transaction came within the protections of the '33 and '34 Acts.[46] Relying on the Supreme Court's *Forman* analysis,[47] the Tenth Circuit held that the economic realities of the plaintiff's purchase of one hundred percent of the stock of the liquor store was not a security transaction under the federal securities laws because the purchase was not an investment in which the plaintiff expected to earn a profit solely from the efforts of others.[48]

The Seventh Circuit in *Frederiksen v. Poloway*[49] adopted the sale of business doctrine in an action alleging failure to disclose and misrepresention of certain material facts in connection with the purchase of a corporation engaged in selling, servicing and storing boats.[50] The parties to the agreement structured the transaction as a sale of one hundred percent of the outstanding shares in the corporation and agreed to the continued employment of the previous owner as manager.[51] The plaintiffs contended that the interests they acquired in the sale were "securities" within the meaning of the federal securities laws.[52] The district court dismissed the plaintiffs' claim on the ground

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43. *See, e.g.*, King v. Winkler, 673 F.2d 342, 343, 346 (11th Cir. 1982) (100% stock transfer not security transactions under federal securities laws); Frederiksen v. Poloway, 637 F.2d 1147, 1154 (7th Cir.) (purchase of 100% of stock of business not security within meaning of securities acts), *cert. denied*, 451 U.S. 1017 (1981); Chandler v. Kew, inc., 691 F.2d 443, 444 (10th Cir. 1977) (receipt of 100% of stock in liquor store holding company is indicia of store's ownership not security transaction covered by federal securities laws).

44. 691 F.2d 443 (10th Cir. 1977).

45. *Id.* at 443.

46. *Id.; see* 15 U.S.C. § 77b(1) (1982) (defining "security" in '33 Act); *id.* § 78c(a)(10) (1982) (defining "security" in '34 Act).

47. *Id.* at 443-44. The *Chandler* court stated that *Forman* held that Congress intended application of the securities laws to depend on the economic realities underlying a transaction. *Id.* at 444. The *Chandler* court held that *Forman* rejected any suggestion that a sale of stock is a security transaction merely because the statutory definition of a security includes the words "any . . . stock." *Id.* at 443; *see* 15 U.S.C. § 77b(1) (1982) (defining "security" in '33 Act); 15 U.S.C. § 78c(a)(10) (1982) (defining "security" in '34 Act).

48. *See* 691 F.2d at 444.

49. 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

50. *Id.* at 1148.

51. *Id.* at 1148-49. The transactions in *Frederiksen* included an employment agreement between the plaintiffs and the former owner who would manage the corporation and receive a salary and a 20% commission on sales. *Id.* The plaintiffs in *Frederiksen* sought to recover actual damages and lost profits based on the defendant's alleged violation of the securities acts. *Id.* at 1149. The plaintiffs also asserted pendent state claims for breach of the Illinois Blue Sky Laws, common-law fraud, and breach of contract. *Id.*

52. *Id.* at 1149-50. On appeal to the Seventh Circuit, the plaintiffs in *Frederiksen* argued that because the literal wording of the federal securities laws included the term "stock", a legal presumption existed that the plaintiffs' purchase of the defendant's stock was a security transaction. *Id.* at 1150.

that the transaction did not involve a "security" under the '33 and '34 Acts.[53] In a two-step analysis, the Seventh Circuit affirmed the district court's ruling.[54] Relying on *Forman*, the court noted in the first step of its analysis that the congressional purpose of the federal securities laws was to protect investors.[55] The Seventh Circuit recognized a dichotomy between commercial transactions and investments as the key to defining the scope of the securities laws and concluded that the securities laws do not apply to commercial transactions.[56]

Determining that Congress intended the securities laws to protect investors, not entrepreneurs, the court in the second step of its analysis examined whether the acquired interests constituted securities.[57] Again relying on *Forman*, the *Frederiksen* court cited three factors against the plaintiffs' literal approach to defining a security.[58] First, the definition of "security" in the securities acts is qualified by the phrase "unless the context otherwise requires."[59] In this sense, a transaction is not a security if the economic context of the transaction shows that the transaction is for commercial rather than investment purposes.[60] Second, a statute may not govern conduct within the reach of the statute if that conduct was not within the framer's intention.[61] The *Frederiksen* court implied that even though the federal securities laws list "stock" within the detinition of a security, Congress may not have intended that all transactions called "stock" be treated as securities.[62] Third, *Forman* rejected a literal approach in favor of an economic realities test.[63] The *Frederiksen* court determined that *Forman* and its progeny specifically rejected a literal approach to defining a security.[64]

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53. *Id.* at 1149.

54. *Id.* at 1149-54.

55. *Id.* at 1150.

56. *Id.* The *Frederiksen* court compared transactions for investment purposes with transactions motivated by a desire to use, consume, occupy or develop. *Id.; see* Canadian Imperial Bank of Commerce Trust Co. v. Fingland, 615 F.2d 465, 470 (7th Cir. 1980) (bank certificates of deposit were commercial transactions, not investments for profit); Emisco Indus., Inc. v. Pro's Inc., 543 F.2d 38, 41 (7th Cir. 1976) (note given as partial consideration for purchase of business assets is not investment because no reliance on profit producing efforts of others). Relying on the language in *Forman* that the securities laws do not apply when the purchaser's goal is to use or consume the item purchased, the *Frederiksen* court held that such transactions are commercial and therefore not covered by the securities acts. 637 F.2d at 1150.

57. *See* 637 F.2d at 1150-52.

58. *Id.* at 1150-51.

59. *Id.* at 1150; *see* 15 U.S.C. § 77b(1) (1982) ("security" unless context otherwise requires); *id.* § 78(c)(a)(10) (1982) (same). The *Frederiksen* court assumed that the prefatory clause "unless the context otherwise requires" contained in the federal securities laws' definitions of a security referred to the economic context of a transaction. *See* 637 F.2d at 1150. An instrument listed within the statutory definition of a security is not a security if the surrounding facts show that the instrument is an economic transaction different from a security. *Id.*

60. *See supra* note 59.

61. *See* 637 F.2d at 1150.

62. *Id.; see* Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892) (legislative enactment may be within letter of statute but not actually within statute because not within spirit of statute or not within intention of statute's makers).

63. *See* 637 F.2d at 1150-51.

64. *Id.; see* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848 (1975) (reject-

Abandoning the literal approach and applying the *Howey* economic reality test to the transactions in *Frederiksen*, the court applied the sale of business doctrine because the plaintiff did not expect to derive profits from the efforts of others.[65] The facts showed that the plaintiff controlled and operated the business, and therefore the transaction failed the third prong of the *Howey* economic reality test which requires reliance on the profit making efforts of others.[66] The *Frederiksen* court concluded that the transaction did not come within the scope of the federal securities laws.[67]

Like the Tenth and Seventh Circuits, the Eleventh Circuit adopted the sale of business doctrine in *King v. Winkler*.[68] In *Winkler*, the court considered whether a transaction involving a private sale of all of a sole stockholder's shares to purchasers who intended to operate and manage the business personally constituted a security transaction under the federal securities laws.[69] Relying on *Forman*, the court rejected a literal test holding that the *Howey* economic realities test was the appropriate standard to determine whether a transaction involving the stock of a corporation was a security transaction.[70] Applying the *Howey* economic reality test to the facts in *Winkler*, the Eleventh

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ing form of instrument in favor of substance of transaction in defining security); *see also* Tcherepin v. Knight, 389 U.S. 332, 336 (1967) (placing substance over form to define term "security" within '33 and '34 Acts).

65. *See* 637 F.2d at 1152-53; Emisco Indus., Inc. v. Pro's Inc., 543 F.2d 38, 41 (7th Cir. 1976) (transaction is investment if investor relied on present and future profit producing efforts of another).

Examining the requirement that an investor rely on the efforts of another to produce profits, the *Fredriksen* court cited with approval the Ninth Circuit's test in *SEC v. Glenn W. Turner Enters. See* 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). In *Turner Enterprises*, the Ninth Circuit stated that the reliance requirement was satisfied if the efforts made by persons other than the investor are essential managerial efforts which affect the failure or success of the enterprise. *Id.*

66. *See* 637 F.2d at 1153; *supra* text accompanying note 14 (three part *Howey* economic realities test).

67. *Id.* at 1154.

68. 673 F.2d 342 (11th Cir. 1982).

69. *Id.* at 343. The parties in *Winkler* structured the transaction so that the defendant sold all stock in North Georgia Mechanical Company to the plaintiffs. *Id.* North Georgia Mechanical then acquired the stock of the defendant's other corporation, North Georgia Mobile Homes Supply, Inc. *Id.* The plaintiffs controlled the management and operation of both businesses and retained the defendant as an employee for a period of time after closing the sale. *Id.*

70. *Id.* at 345. The *Winkler* court held that the *Howey* economic realities test was appropriate to determine whether a corporate stock transaction was a "security transaction" or an "investment contract" within the definition of the '33 and '34 Acts. *Id.* As additional support for rejecting a literal approach to defining a security, the *Winkler* court cited cases rejecting a literal approach to defining a promissory note. *Id.; see* National Bank of Commerce v. All American Assurance Co., 583 F.2d 1295, 1302 (5th Cir. 1978) (commercial loan on promissory note, with pledged securities as collateral is not security transaction); Woodward v. Metro Bank, 522 F.2d 84, 92-93 (5th Cir. 1975) (acknowledging dichotomy between commercial transactions and investments as key to whether note is security but failing to apply distinction to case); McClure v. First National Bank, 497 F.2d 490, 492 (5th Cir. 1974) (note and trust deed given by corporation to bank for loan were not securities), *cert. denied*, 420 U.S. 930 (1975); Bellah v. First National Bank, 495 F.2d 1109, 1113-14 (5th Cir. 1974) (note and deed of trust securing note not securities within meaning of '34 Act).

Circuit concluded that since the plaintiffs assumed the management and control of a business and expected no profit from the entrepreneurial or managerial efforts of others, the transaction was not a security transaction.[71] The *Winkler* court held that in substance the purchasers bought and the sellers sold a business, and therefore the sale of business doctrine was applicable.[72]

In contrast to the circuits adopting the doctrine, three circuits reject the sale of business doctrine.[73] In *Golden v. Garafalo*,[74] the Second Circuit strongly repudiated the sale of business doctrine in favor of a literal approach to defining a security.[75] The plaintiffs in *Golden* purchased from the defendant one hundred percent of the outstanding stock of a ticket brokerage business which the plaintiffs intended to manage directly.[76] The plaintiffs alleged that the defendant violated the securities laws by misrepresenting the value of the business, and therefore the value of the stock.[77]

The *Golden* court rejected the sale of business doctrine, holding that the '33 and '34 Acts' definition of "security" included instruments that have the

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71. *See* 673 F.2d at 344-45.

72. *Id.* at 346.

73. *See, e.g.*, Daily v. Morgan, 701 F.2d 496, 497 (5th Cir. 1983) (sale of ordinary corporate stock in business to buyer who plans to manage and control business subjects parties to antifraud provisions of federal securities laws); Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227, 230 (2d Cir. 1982) (reaffirming Second Circuit's earlier rejection of sale of business doctrine in *Golden*); Golden v. Garafalo, 678 F.2d 1139, 1140 (2d Cir. 1982) (conventional stock in business corporations is security within meaning of '33 and '34 Acts whether or not underlying transaction involved sale of business to one who intends to manage business); Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.) (purchaser of ordinary corporate stock was not denied protection of federal securities laws simply because purchaser intended to participate in management of business), *cert. denied*, 444 U.S. 868 (1979); Occidental Life Ins. Co. v. Pat Ryan & Associates, Inc., 496 F.2d 1255, 1263 (4th Cir.) (allowing application of antifraud provisions of securities laws to depend upon percentage of shares involved in transaction would lead to "capricious" results), *cert. denied*, 419 U.S. 1023 (1974). A number of commentators contend that the Third Circuit rejected the sale of business doctrine in *Glick v. Campagna*. *See* 613 F.2d 31, 35 (3d Cir. 1979); *Repudiating, supra* note 7, at 1724 n.40 (Third Circuit expressly rejected sale of business doctrine in *Glick v. Campagna*); Prentice & Roszkowski, *supra* note 7, at 475 n.11 (Third Circuit rejected sale of business doctrine); Seldin, *supra* note 7, at 641 n.9. (Third Circuit rejected sale of business doctrine in *Glick v. Campagna*). A careful reading of *Glick v. Campagna*, however, does not support the conclusion that the Third Circuit has rejected expressly the sale of business doctrine. *See* Glick v. Campagna, 613 F.2d 31, 35 (3d Cir. 1979) (although the sale of 50% of stock constituted sale of security, court did not reject expressly sale of business doctrine). Currently, the Third Circuit is considering whether to accept or reject the doctrine in a pending decision. *See* Ruefenacht v. O'Halloran, No. 83-5493 (3d Cir. filed Dec. 7, 1983). United States district courts within the Third Circuit have both accepted and rejected the sale of business doctrine. *Compare* Goodman v. De Azoulay, 554 F. Supp. 1029, 1032-33 (E.D. Pa. 1983) (accepting sale of business doctrine because transaction failed *Howey* economic realities test) *with* Bronstein v. Bronstein, 407 F. Supp. 925, 929 (E.D. Pa. 1976) (rejecting sale of business doctrine because bona fide shares and capital stock of corporation are securities).

74. 678 F.2d 1139 (2d Cir. 1982).

75. *Id.*

76. *Id.* at 1140. The parties in *Golden* structured the transfer as a sale of shares rather than assets because the corporation held non-assignable leasehold rights to certain office space. *Id.*

77. *Id.*

characteristics associated with ordinary stock.[78] The *Golden* court disagreed with the Seventh Circuit's interpretation of *Forman* that the *Frederiksen* decision presented.[79] The Second Circuit maintained that *Forman* did not establish the *Howey* economic realities test as the exclusive determinant of the status of instruments as securities under the '33 and '34 Acts.[80] The *Golden* court instead recognized the two part *Forman* analysis as the proper test of the existence of a security.[81] The court noted that the first step of the *Forman* test inquired whether the instruments were "stock" and examined the characteristics commonly associated with stock including rights to dividends, voting rights in proportion to shareholdings, ability to appreciate in value, and transferability.[82] The *Golden* court maintained that the Court in *Forman* examined the instruments to determine if they represented an investment with an expectation of profit from the efforts of others only after first determining that the instruments were not conventional stock.[83] The *Golden* court interpreted *Forman* to mean that if an instrument has the characteristics of ordinary stock, the securities laws apply and a court should not apply the *Howey* economic realities test.[84] The *Golden* court held that conventional stock in a business corporation is a security as defined by the federal securities laws regardless of whether the underlying transaction involves the sale of a business to a person who intends to manage it.[85]

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78. *Id.* at 1144. The *Golden* court maintained that Congress would not have included the specific term "stock" within the statutory definition of a security if Congress did not intend to include all such instruments as commonly defined. *Id.* The court held that Congress included catch-all phrases like "investment contract" to cover unique instruments not easily classified. *Id.*

79. *Id.* The *Golden* court held that since both *Howey* and *Forman* involved unique or idiosyncratic instruments, any language in *Forman* suggesting that the *Howey* economic realities test must be applied to all instruments to determine whether the instruments are securities was dicta. *Id.*

80. *See supra* note 79.

81. *See* 678 F.2d at 1144.

82. *Id.* The *Golden* court concluded that the first part of the "*Forman* test" seemed to focus more on the legal status of the instrument rather than the economic realities underlying the transaction. *Id.*

83. *Id.* The *Golden* court concluded that the *Forman* analysis was inconsistent with the sale of business doctrine. *Id.* The court maintained that if the *Howey* economic realities test determines whether an instrument is a security under the '33 and '34 Acts, then the *Forman* Court did not need to first examine whether the shares were stock as defined by conventional criteria. *Id.*

84. *Id.* In addition to rejecting the sale of business doctrine based on a contrary interpretation of *Forman*, the *Golden* court repudiated the doctrine on policy grounds. *Id.* at 1145-46. The Second Circuit considered the sale of business doctrine too uncertain because the doctrine would make unclear the scope of the securities laws. *Id.* Interpreting Supreme Court precedent and examining policy considerations, the Second Circuit explicitly rejected the sale of business doctrine. *Id.* at 1144-46.

85. *Id.* at 1144. The lengthy dissent in *Golden* maintained that the majority extended federal securities laws protections to plaintiffs who did not need federal protection. *Id.* at 1147. The dissent concluded that the majority's expansion of the scope of the '33 and '34 Acts additionally would burden the federal courts without furthering any congressional purpose. *Id.* In support of the dissent's conclusion that the stock purchased by the plaintiffs was not a security under the securities laws, the dissent maintained that the majority misconstrued the Supreme Court's

The Fourth Circuit rejected the sale of business doctrine in *Coffin v. Polishing Machines, Inc.*[86] In *Coffin*, the plaintiff purchased fifty percent of the stock of a corporation and assumed duties as executive vice president of the corporation.[87] The plaintiff sued in the United States District Court for the Eastern District of Virginia alleging that the defendant made materially false and misleading representations in connection with the stock purchase.[88] Dismissing the case on the pleadings,[89] the district court maintained that under the *Howey* economic realities test established in *Forman*, even ordinary corporate stocks are not securities under the federal laws if the instruments do not represent interests in an enterprise from which the investor seeks to gain a profit solely from the efforts of others.[90] The district court held that the

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Forman analysis. *Id.* at 1148. The dissent observed that the *Forman* Court applied a two part test only in response to the alternate grounds for the Second Circuit's holding. *Id.; see* Forman v. Community Services, Inc., 500 F.2d 1246, 1250-55 (2d Cir. 1974) (share in non-profit housing cooperative is both "stock" and "investment contract") The *Golden* dissent concluded that nothing in the *Forman* decision suggested that courts must apply a two part analysis or that an initial determination that an instrument possesses the common characteristics of corporate stock forecloses an inquiry into the economic reality of the transaction. *See* 678 F.2d at 1148.

In addition to disagreeing with the majority's interpretation of *Forman*, the dissent maintained that *Marine Bank v. Weaver* supports the application of the sale of business doctrine. *See* Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982); 678 F.2d at 1148-49. The dissent stated that *Weaver* denied the protections of the federal securities laws to the purchasers of a bank certificate of deposit even though the instrument seemed to satisfy the statutory definition of a security. *Id.* at 1149. In removing an instrument commonly known as a security from the statutory definition of a security, the *Weaver* court relied on the definition's preceding "context" clause to find that holders of bank certificates of deposit did not need the protection of the securities laws. *See* Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982). The *Golden* dissent concluded that the plaintiffs did not need the protections of the securities laws because the plaintiffs could have inspected the business prior to purchase. 678 F.2d at 1149. The plaintiffs obtained specific warranties and representations regarding the business' tangible and intangible assets. *Id.* In addition, the plaintiffs assumed full operational control of the business from the moment the plaintiffs signed the purchase agreement. *Id.*

Finally, the *Golden* dissent disagreed with the majority's conclusion that application of the sale of business doctrine would lead to uncertain results. *Id.* The dissent noted that courts accepting the sale of business doctrine have not experienced unusual difficulties in applying the doctrine. *Id.; see e.g.*, King v. Winkler, 673 F.2d 342 (11th Cir. 1982) (applying sale business doctrine); Canfield v. Rapp & Son, 654 F.2d 459 (7th Cir. 1981 (same); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.) (same), *cert. denied*, 451 U.S. 1017 (1981); Chandler v. Kew, 691 F.2d 443 (10th Cir. 1977) (same). The *Golden* dissent dismissed the majority's additional fears that the doctrine might interfere with business planning, noting that parties to a transaction may protect their interests by contract. 678 F.2d at 1149-50. The dissent concluded that the purchase of 100% of the stock of a business that the buyer intends to manage is not a security transaction within the securities laws and therefore the court lacked subject matter jurisdiction. *Id.* at 1150.

86. 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

87. *Id.* at 1203.

88. *Id.* The plaintiff in *Coffin* sued to recover damages under the federal securities acts, the Virginia Blue Sky statute, and common law fraud. *Id.*

89. *Id.* at 1204; *see* FED. R. CIV. P. 12(b)(1) (lack of subject matter jurisdiction); FED. R. CIV. P. 12(b)(6) (failure to state claim upon which relief can be granted).

90. *See* 596 F.2d at 1204; *see also* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848-58 (1975) (not every sale of stock within coverage of federal securities laws); SEC v.

stock purchase was the sale of a half interest in a business and not an investment because the plaintiff was a substantial contributor to the management of the corporation.[91]

The Fourth Circuit reversed the district court, maintaining that *Forman* did not deny a purchaser of ordinary corporate stock the protection of the securities laws simply because the purchaser intends to manage the corporation.[92] The court adopted a literal approach to defining a security, holding that when a transaction involves stock the securities laws apply.[93] The *Coffin* court interpreted *Forman* to require a two part analysis,[94] noting that the *Howey* economic realities test should apply to the substance of a transaction only after determining that the instruments do not have the characteristics commonly associated with stock.[95]

In *Daily v. Morgan*,[96] the Fifth Circuit joined the Second and Fourth Circuits in expressly rejecting the sale of business doctrine.[97] In *Daily*, the plaintiffs purchased all issued shares of the stock in a truck dealership and assumed managerial control of the business after the sale.[98] When the parties executed the bill of sale, the plaintiffs obtained an audit of the business which prompted the plaintiffs to bring suit alleging that the defendants had given inaccurate, incomplete, and misleading financial information about the business at the time of the sale.[99] The *Daily* court rejected the defendant's argument that one who purchases an entire business with an intent to manage the business does not need the protection of the federal securities laws simply because the purchaser has an opportunity to inspect the business.[100] The court reasoned

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W.J. Howey Co., 328 U.S. 293, 298 (1946) (stock is security if stock represents interest in enterprise from which investor derives profit from others' efforts).

91. *See* 596 F.2d at 1204.

92. *Id.*

93. *Id.; see* Occidental Life Ins. Co. v. Pat Ryan & Associates, Inc., 496 F.2d 1255, 1261 (4th Cir.) (strong presumption that securities laws apply when transaction involves stock), *cert. denied*, 419 U.S. 1023 (1974).

94. 596 F.2d at 1204.

95. *Id.* The *Coffin* court, however, rejected the sale of business doctrine in a case that did not involve the purchase of a business. *Id.; see* Frederiksen v. Poloway, 637 F.2d 1147, 1151 (7th Cir.) (*Coffin* involved sale of corporate stock to raise capital for profit-making purposes, not sale of business). The court in *Coffin* stated that the defendant corporation sold stock to finance corporate expansion. *See* 596 F.2d at 1204. The Fourth Circuit acknowledged that the transaction in *Coffin*, the sale of securities to raise capital, epitomized the primary concern of Congress in enacting the federal securities laws. *Id.; see* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975) (federal securities laws concerned with sale of securities to raise capital for profit-making purposes).

96. 701 F.2d 496 (5th Cir. 1983).

97. *Id.* at 497; *see* Golden v. Garafalo, 678 F.2d 1139, 1140 (2d Cir. 1982) (rejecting sale of business doctrine because "stock" is security); Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.) (same), *cert. denied*, 444 U.S. 868 (1979).

98. *See* 701 F.2d at 497.

99. *Id.* The plaintiffs in *Daily* brought suit under SEC rule 10b-5 and pendent state law claims. *Id.*

100. *Id.* at 502-03. The *Daily* court contrasted the opportunity to inspect the business available

that the reliance and materiality requirements of rule 10b-5 undermine the argument.[101] The court noted that if a plaintiff-purchaser had an opportunity to inspect the business, the defendant-seller could argue that the plaintiff did not rely upon the alleged misrepresentations or omissions or that the misrepresentations or omissions were not material.[102]

The *Daily* court also concluded that adoption of the sale of business doctrine would lead to a slippery slope regarding the scope of the '33 and '34 Acts because the percentage of stock necessary to exclude a purchaser from the protections of the federal securities laws and the interpretation of the requirement that profits come from the efforts of others make consistent application of the doctrine a problem.[103] The court also stated that a rule depending on transfer of control would eliminate tender offers from securities laws coverage.[104] On balance, the court concluded that adoption of the sale of business doctrine would lead to marginal gain.[105] Additionally, the *Daily* court rejected the argument that the sale of business doctrine would prevent arbitrary application of the securities laws.[106] The Fifth Circuit noted that by structuring the sale as a stock transfer, parties create an expectation that the securities laws apply to the transaction.[107] The court also reasoned that adoption of the doctrine would create its own arbitrary results.[108] For example, a defrauded purchaser of fifty one percent of the stock of a corporation may have no federal remedy, while a partner who purchases forty nine percent of the stock has a remedy under the federal securities laws.[109] The *Daily* court rejected the sale of business doctrine, concluding that policy agruments require

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to an entrepreneur with a passive investor's lack of first hand knowledge about the business. *Id.* at 502. The court noted that an investor must rely on information given by the seller. *Id.* The court, however, rejected the distinction between entrepreneurs and investors as immaterial to the need for protection of the securities laws. *Id.* at 502-03.

101. *Id.* To sustain a claim under rule 10b-5, a plaintiff must show a misstatement of material fact, made with scienter, on which the plaintiff relied, that proximately caused the plaintiff's injury. *See* Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir. 1981) (elements necessary to prove § 10(b) claim have become black letter law), *reversed in part on other grounds*, ___ U.S. ___, 103 S. Ct. 683 (1983).

102. *See* 701 F.2d at 502-03.

103. *See id.* at 503. The *Daily* court maintained that adoption of the sale of business doctrine would not contribute to bringing the enforcement of SEC rule 10b-5 into conformity with Supreme Court precedent or congressional purpose. *Id.* The court in *Daily* inquired whether insiders or employees who purchase stock would have protection under the federal securities laws if the requirement of the *Howey* economic realities test that profits come solely from the efforts of others is given literal effect. *Id.*

104. *Id.; see* Karjala, *Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. ILL. L. F. 413, 423 (emphasis on control in sale of business doctrine cases would exclude tender offer from coverage of federal securities laws).

105. 701 F.2d at 503.

106. *Id.* at 503-04.

107. *Id.* at 503; *see* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 850 (1975) (use of traditional name such as "stocks" or "bonds" will lead buyer justifiably to assume that securities acts apply).

108. *See* 701 F.2d at 503.

109. *Id.; see* McGrath v. Zenith Radio Corp., 651 F.2d 458, 467-68 n.5 (7th Cir.) (instrument may be security to some parties to transaction but not to other parties), *cert. denied*, 454

the application of the securities laws to the sale of ordinary corporate stock in a business to a buyer who plans to manage and control the business.[110]

The sale of business controversy extends beyond the issue of whether a purchaser of one hundred percent of the stock of a corporation by a person who intends to manage the business constitutes the sale of a security under the federal securities laws.[111] In *Sutter v. Groen*,[112] the Seventh Circuit denied the protection of the securities laws to a purchaser of less than one hundred percent of the stock of a corporation.[113] In *Sutter*, the Seventh Circuit reconsidered the sale of business doctrine in light of the Second Circuit's rejection of the doctrine in *Golden v. Garafalo* and the Supreme Court's decision in *Marine Bank v. Weaver*.[114] The *Sutter* court relied on the *Weaver* decision in refuting the *Golden* court's literal interpretation of *Forman*.[115] The *Sutter* court reasoned that the bank certificate of deposit in *Weaver* was a type of note which is one of the instruments specifically listed in the statutory definition of a security.[116] The *Sutter* court determined that the *Weaver* opinion removed one of the specifically listed instruments from the definition of a security by interpreting the phrase "unless the context otherwise requires" to mean the economic context of a transaction.[117]

U.S. 835 (1981); *infra* notes 127-32 and accompanying text (discussion of *McGrath*).

The *Daily* court noted that under the sale of business doctrine if ten equal shareholders in a business sold the stock to a single purchaser, the sellers would have a remedy under the securities acts but the purchaser would not have a federal remedy. 701 F.2d at 50. The court acknowledged special risks in the sale of a corporation. *Id.* at 504. For example, a person who purchases a business is not liable for the business debt while one who purchases stock assumes the liabilities. *Id.; see* H. HENN. LAW OF CORPORATIONS, § 341 n.30 (1970) (purchaser of shares indirectly assumes corporation's liabilities). The court noted that liabilities often are disclosed inaccurately or incompletely. 701 F.2d at 504.

110. 701 F.2d at 504.

111. *See infra* notes 114-34 and accompanying text (discussion of cases expanding sale of business doctrine).

112. 687 F.2d 197 (7th Cir. 1982).

113. *Id.* at 203. In *Sutter*, the purchaser acquired 70% of the common stock of the corporation. *Id.*

114. *Id.* at 199. The Seventh Circuit reaffirmed *Frederiksen* and the sale of business doctrine in *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 464-65 (7th Cir. 1981). *Id.; see also* Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (federally guaranteed and insured bank certificate of deposit not security); Golden v. Garafalo, 678 F.2d 1139, 1140 (2d Cir. 1982) (purchase of 100% of stock in ticket brokerage business is security despite purchaser's intent to manage business).

115. *See* 687 F.2d at 200-01.

116. *Id.* at 200.

117. *Id.* The *Sutter* court concluded that *Weaver* determined that the bank certificate of deposit was not a security because the economic context surrounding the instrument did not require the protection of the securities laws. *Id.* The *Sutter* court maintained that *Weaver* narrowed the scope of the federal securities laws by disregarding the literal meaning of "security" found in § 3(a)(10) of the '34 Act. *Id.* at 200-01. According to *Sutter*, the *Weaver* court limited the '33 and '34 Acts' protections because Congress never intended that the federal securities laws be a cure for common law fraud. *Id.* Congress defined "security" very broadly but presumably only to prevent the financial community from evading regulation by inventing new types of financial instruments. *Id.* at 201. Congress, however, did not define "security" in a manner to prevent the courts from interpreting the '34 Act in light of the Act's purposes. *Id.*

Rejecting the *Golden* court's literal approach to defining a security, the *Sutter* court concluded that Congress intended to protect investors, not entrepreneurs, by enacting the federal securities laws.[118] The Seventh Circuit in *Sutter* emphasized the importance of distinguishing between an investor and an entrepreneur in that an investor entrusts money to others expecting to profit from the efforts of others,[119] but an entrepreneur seeks profit primarily through his own efforts.[120] Applying the distinction between investor and entrepreneur to the facts, the *Sutter* court concluded that the plaintiff was an entrepreneur.[121]

The plaintiff in *Sutter*, however, acquired less than one hundred percent of the stock in the corporation.[122] The *Sutter* court formulated a presumption applicable in situations in which the purchaser bought a substantial percentage of the stock of the corporation but less than one hundred percent.[123] The court held that ownership of more than fifty percent of the common stock of a corporation leads to the presumption that the purpose in buying the stock was for entrepreneurship rather than for investment.[124] The *Sutter* court stated that a party can rebut the presumption of entrepreneurship by showing that the purchaser's main purpose was investment.[125] By adopting a presumption of entrepreneurship for purchases of less than one hundred percent but more than fifty percent of the stock of a corporation, the Seventh Circuit greatly expanded the scope of the sale of business doctrine.[126]

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118. *Id.; see* President's Message to Congress, February 9, 1934 (President Roosevelt recommending enactment of '34 Act for protection of investors); S. REP. No. 792, 73d Cong., 2d Sess. 2, 5 (1934) (report of Senate Committee on Banking and Currency describing objective of legislation as protection of investors).

119. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1190 (1981) ("investor" is one who seeks to commit funds for long-term profit with minimum risk).

120. *See* BLACK'S LAW DICTIONARY 478 (5th ed. 1979) ("entrepreneur" is person who, on his own, initiates and assumes financial risks of new enterprise and undertakes its management). The *Sutter* court recognized a clear distinction between investors and entrepreneurs. *See* 687 F.2d at 201. The court noted that while sometimes a person can be both an investor and an entrepreneur, often the person is one or the other. *Id.*

121. *See* 687 F.2d at 201-03. Applying the dichotomy between investors and entrepreneurs to the facts in *Sutter*, the *Sutter* court held that the sale of the defendants' stock to Happy Radio was a transfer of 100% of the common stock to Bret Broadcasting. *Id.* at 202. Since the defendants retained no role in the company, the transaction required the application of the sale of business doctrine. *Id.* concerning the plaintiff's purchase of stock in Happy Radio, however, the court inquired whether the plaintiff created Happy Radio as a corporate vehicle for acquiring the assets of Bret Broadcasting or whether the plaintiff was just an investor in Happy Radio. *Id.* at 202-03.

122. *See supra* note 113 (plaintiff in *Sutter* acquired only 70% of stock in Happy Radio).

123. *See* 687 F.2d at 203. The *Sutter* court formulated a presumption of entrepreneurship for purchases of a bloc of stock less than 100% of the corporation to guide the district court on remand. *Id.*

124. *Id.*

125. *Id.*

126. *See id.* The *Sutter* court maintained that the greater than 50% entrepreneurial presumption was consistent with the distinction between entrepreneurial and investment objectives in purchasing stock. *Id.* The court reasoned that the dichotomy between entrepreneurs and investors was fundamental to determining the intended reach of the '33 and '34 Acts and SEC rules. *Id.*

The Seventh Circuit further refined the sale of business doctrine in *McGrath v. Zenith Radio Corp.*[127] In *McGrath*, the court considered whether the plaintiff's waiver of a stock purchase option and sale of shares in reliance on the defendant's promise of future employment constituted a violation of the securities laws.[128] Holding that the sale of plaintiff's shares gave the plaintiff standing to assert a violation of the securities laws, the *McGrath* court noted that the plaintiff was one of a number of employees who invested in and subsequently sold stock.[129] The shares represented investments by the individual employees who held the shares and therefore constituted securities in the hands of the plaintiff and other sellers.[130] The sellers' shares did not lose their status as securities even though the purchaser bought all of the shares in the same transaction.[131] An instrument, therefore, may be a "security" to some parties to a transaction but not to others.[132]

Courts accepting the sale of business doctrine rely on legislative history of the securities laws and Supreme Court precedent to hold that the sale of one hundred percent of, or a controlling interest in, a corporation's stock with intent to manage the business is not a security transaction.[133] Although

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127. 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981). The *McGrath* case concerned the acquisition of an electronic products wholesaler by Zenith Radio Corporation (Zenith). *Id.* at 461. The plaintiff, vice president and general manager of the acquired company, held an option to purchase up to five thousand shares of the company stock. *Id.* at 461-62. Since Zenith wanted to acquire all of the target company's stock, Zenith requested the plaintiff to waive the option to purchase additional shares. *Id.* at 462. The plaintiff purchased 2,835 shares of the company's stock in September and October 1971. *Id.* Zenith's treasurer asked the plaintiff to waive the option to purchase an additional 2,165 shares of the acquired company's stock. *Id.* The plaintiff alleged that Zenith made oral representations to the plaintiff during the waiver negotiations that Zenith would appoint the plaintiff as president of the acquired company upon the retirement of the company's then current chief officer. *Id.* The plaintiff asked for a three year employment contract with the acquired company, but Zenith's treasurer's declined to enter into a contract, stating that Zenith's policy precluded employment contracts with Zenith executives. *Id.* The plaintiff, therefore, accepted Zenith's oral statements that the plaintiff would be the next president of the acquired company. *Id.* Zenith subsequently fired the plaintiff. *Id.* at 463.

128. *Id.* at 463-64.

129. *Id.* at 467-68 n.5.

130. *Id.*

131. *Id.*

132. *Id.* The *McGrath* court denied any indication that *Frederiksen v. Poloway* required a result contrary to *McGrath*. *Id.* In *McGrath*, the shares constituted securities to the individual sellers, but under *Frederiksen* would not constitute securities to the buyer. *Id. But see* Daily v. Morgan, 701 F.2d 496, 514 (5th Cir. 1983) (sale of business doctrine may lead to anomalous and asymmetrical result that one party to transaction protected by federal securities laws while other party not protected).

133. *See supra* note 7 (listing commentaries on sale of business doctrine). The traditional formulation of the sale of business doctrine provides that a purchase of 100% of the stock of a corporation with intent to manage the business is not a security transaction within the protection of the federal securities laws. *See* King v. Winkler, 673 F.2d 342, 346 (11th Cir. 1982) (private sale of all of sole shareholder's corporate stock to purchasers who intend to operate and manage business personally is not security transaction controlled by '33 or '34 Acts); Frederiksen v. Poloway, 637 F.2d 1147, 1150-54 (7th Cir.) (acquisition of 100% of stock in marina did not involve "security" within meaning of '33 and '34 Acts), *cert. denied*, 451 U.S. 1017 (1981); Chandler v. Kew, Inc.,

the '33 and '34 Acts specifically include the term "stock" in the definition of a security.[134] courts adopting the sale of business doctrine reject a literal approach to the definition of a security.[135] Rather, courts espousing the sale of business doctrine favor an economic realities test which examines the transaction to determine whether the transaction is an investment in a common venture with an expectation of profits from the efforts of others.[136] Courts embracing the sale of business doctrine interpret the *Forman* decision to require the application of the *Howey* economic realities test to every transaction to determine whether the federal securities laws control the transaction.[137]

In contrast, courts rejecting the sale of business doctrine use a literal approach to determine whether an instrument is a security.[138] Ordinary stock is a security because "stock" is a term specifically listed in the statutory definition of a security.[139] Courts using the literal approach also rely on *Forman*, but interpret the decision as requiring a two-step analysis to determine whether an instrument is a security.[140] Initially, a court must examine the instrument

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691 F.2d 443, 444 (10th Cir. 1977) (transaction in which plaintiff bought liquor store and as indicia of ownership received 100% of stock of company owning store was not "security transaction" within purview of federal securities laws). Recently, however, a number of courts have held that acquisition of a controlling interest of less than 100% of the stock of a corporation with intent to manage the business is not a security transaction protected by the '33 and '34 Acts. *See* Sutter v. Groen, 687 F.2d 197, 203 (7th Cir. 1982) (acquisition of more than 50% of corporation's common stock leads to presumption that purchase was for commercial rather than investment purposes); Oak Hill Cemetery of Hammond, Inc. v. Tri-State Bank, 513 F. Supp. 885, 890 (N.D. Ill. 1981) (purchase of control block of stock not security transaction even though transaction involved less than 100% of outstanding shares).

134. *See* 15 U.S.C. § 77b(1) (1982) (term "stock" included within statutory definition of security); *id.* § 78c(a)(10) (term "stock" specifically listed as instrument commonly known as security).

135. *See infra* note 136.

136. *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849-50 (1975) (rejecting literal approach to definition of "security" in favor of *Howey* economic realities test); *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946) (developing three-part economic realities test).

137. *See supra* notes 18-30 and accompanying text (discussion of *Forman*); *supra* notes 8-16 and accompanying text (discussion of *Howey*); *see also supra* note 6 (courts accepting sale of business doctrine).

138. *See supra* note 7 (courts rejecting sale of business doctrine).

139. *See* 15 U.S.C. § 77b(1) (1982) (term "stock" included within statutory definition of security); *id.* § 78c(a)(10) (term "stock" specifically listed as instrument commonly known as security); *see* Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982) (term "stock" includes instruments which have characteristics associated with ordinary conventional shares of stock).

140. *See* Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982); *see also* Brunelle, *The "Sale of Business" Controversy in the Definition of the Term "Security,"* 10 SEC. REG. L.J. 377, 381-84 (*Golden's* two-step analysis of *Forman* is workable approach to sale of business controversy). Brunelle outlined five advantages to the two-step *Forman* analysis developed in *Golden*. *See id.* at 381-82. First, the *Golden* Court's definitional approach obviates inquiries about whether a purchaser acquired "control." *Id.* at 381. Second, the *Golden* court's analysis minimizes confusion and risk in corporate planning. *Id.* Third, the *Golden* court's definitional criteria are reasonable. *Id.* at 382. Fourth, the *Golden* court's definitional criteria are in accord with *Forman* in that the criteria require that the instrument in question be stock in fact and not merely stock in name. *Id.* Finally, the *Golden* criteria are objective. *Id.*

to determine whether the instrument has the attributes commonly associated with the named instrument.[141] For example, if an instrument called stock possesses the traditional attributes associated with stock, then the instrument is a security and the court need not proceed to the next step of the analysis.[142] If, however, the instrument does not possess the characteristics typically associated with stock, the court may apply the *Howey* economic realities test to determine whether the instrument is an investment contract.[143] Courts rejecting the sale of business doctrine maintain that they need not resort to the *Howey* economic realities test unless the named instrument fails the first step of the *Forman* analysis.[144]

In addition to rejecting a literal approach, courts accepting the sale of business doctrine argue that the congressional purpose surrounding the '33 and '34 Acts is to protect investors, not entrepreneurs.[145] Further, Congress drafted the '33 and '34 Acts to require full disclosure of material information so that purchasers can make informed investment decisions.[146] Courts accepting the doctrine maintain that Congress enacted the securities laws to protect investors in public markets but that entrepreneurs do not need the protection of the federal securities laws since entrepreneurs can inspect any business they might purchase and can demand material information from the seller.[147]

Courts repudiating the sale of business doctrine reject the dichotomy between investors and entrepreneurs.[148] Courts which reject the doctrine maintain not only that "entrepreneurs" need the protection of the '33 and '34 Acts, but also that a difficult question arises in deciding whether a person is an entrepreneur or an investor.[149] For example, a purchaser of a business

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141. *See Golden*, 678 F.2d at 1144.

142. *Id.*

143. *Id.; see* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946) (setting out three-part investment contract test).

144. *See* 678 F.2d at 1144.

145. *See supra* note 3 (one purpose of '33 and '34 Acts is investor protection).

146. *See supra* note 3 (one purpose of federal securities laws is disclosure).

147. *See* Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982) (investors are only protected class mentioned in securities laws' legislative history); *see also* 15 U.S.C. § 78b (1982) (purpose of '34 Act to protect investors in public exchanges); Fredriksen v. Poloway, 637 F.2d 1147, 1150 (7th Cir.) (entrepreneurs do not need protection of federal securities laws), *cert. denied*, 451 U.S. 1017 (1981). *But see* Daily v. Morgan, 701 F.2d 496, 502-03 (5th Cir. 1983) (rejecting argument that person who purchases entire business with intent to manage business does not need protection of federal securities laws because purchaser has opportunity to inspect); *cf.* Golden v. Garafalo, 678 F.2d 1139, 1148 (2d Cir. 1982) (Lumbard, J., dissenting) (plaintiffs in position to inspect business before purchase).

148. *See* 678 F.2d at 1146 (purchasers of business regard themselves as investors and managers). In rejecting the dichotomy between an investor and an entrepreneur, the *Golden* court noted that corporate control transfers often are motivated by a desire for capital gains resulting from improved management. *Id.* The court concluded that classifying such transactions as exclusively commercial constituted artificial classifications. *Id.*

149. *See* Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983) (basing application of federal securities laws on "control" would lead to slippery slope); *supra* note 148 (recognizing problem in classifying persons as investors or entrepreneurs).

is also an investor in a corporation.[150] Furthermore, courts rejecting the doctrine contend that the size of the sale and the bargaining power or sophistication of the purchaser do not affect the coverage of the '33 and '34 Acts.[151]

Supreme Court cases defining a "security" sanction the sale of business doctrine.[152] The *Howey* decision established the economic realities test as the test of a security.[153] Under the *Howey* economic realities test, an instrument is a security if the transaction is an investment in a common enterprise with an expectation of profits from the efforts of others.[154] Purchasers of a business who intend to manage the business do not rely on others to make profits.[155] Therefore, a purchaser of a business does not need the protection of the federal securities laws because the purchaser is not relinquishing control over his investment to a third party.[156]

In defining a security, the Supreme Court in *Forman* rejected a literal approach, which specifies that any instrument labeled "stock" is a security, in favor of the *Howey* economic realities test.[157] The *Forman* Court explicitly rejected any suggestion that a transaction in shares called "stock" is a security merely because the '33 and '34 Acts' definition of a security includes the term "stock."[158] The Court held that the substance of a transaction rather than

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150. *See supra* note 148 (*Golden* court acknowledged that persons who purchase corporation make investment in business); *see also* Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982) (person may be both investor and entrepreneur at same time).

151. *See supra* notes 148-50 and accompanying text (application of securities laws does not depend on position of parties).

152. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982) (bank certificate of deposit not security because economic context of transaction requires otherwise); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848-52 (1975) (rejecting literal approach to defining "security" in favor of economic realities test to determine whether transaction is security); SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (establishing three-part economic realities test to determine whether transaction is security).

153. *See supra* notes 8-16 and accompanying text (discussion of *Howey*).

154. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (formulation of economic realities test); *see also* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848-52 (1975) (establishing *Howey* economic realities test as determinant of security transaction).

155. *See* Frederiksen v. Poloway, 637 F.2d 1147, 1148 (7th Cir.) (if purchaser assumes "control" of critical decisions of corporation then transaction is not security), *cert. denied*, 451 U.S. 1017 (1981); *see also* SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.) ("reliance" requirement satisfied if persons other than investor make essential managerial decisions), *cert. denied*, 414 U.S. 821 (1973).

156. *See* Thompson, *supra* note 7, at 244 (purchaser must lack control over intangible investment to invoke protection of federal securities laws); *see also* Tech Resources, Inc. v. Estate of Hubbard, 246 Ga. 583, 585, 272 S.E.2d 314, 317 (1980) (lack of control over investment means reliance on anyone other than purchaser for performance of managerial duties to produce profits).

157. *See supra* noes 18-30 and accompanying text (discussion of *Forman*); *see also* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (economic realities test determines whether transaction is "security" within '33 and '34 Acts).

158. *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848 (1975) (explicitly rejecting literal approach to defining security in favor of examination of substance of transaction); *see also* Tcherepin v. Knight, 389 U.S. 332, 336 (1967) (substance considered over form in defining "security").

the form of an instrument involved determines whether the "stock" is a security.[159] Whether an instrument is a security depends on the economic realities of the underlying transaction because securities are economic in character.[160] In addition, the *Forman* Court found no distinction between an investment contract and an instrument commonly known as a security.[161] The Court, therefore, concluded that the *Howey* economic realities test for determining an investment contract was the proper test of a security.[162]

The Second Circuit and other courts taking a literal approach to defining a security overemphasize the importance of the *Forman* decision's two part structural analysis.[163] Courts taking a literal approach conclude that *Forman* established a two part test to determine whether an instrument is a security because the *Forman* Court first examined whether the "stock" in issue possessed attributes commonly associated with stock.[164] After determining that the "stock" did not possess the ordinary characteristics of stock, the *Forman* Court examined whether the "stock" was an investment contract under the *Howey* economic realities test.[165] The two part analysis of *Forman*, however, did not establish two separate tests to determine whether an instrument is a security.[166] The *Forman* Court's two part structural analysis merely reversed in turn each of the lower court's alternative holdings that the "stock" was

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159. *See infra* note 160 (substance of transaction rather than form of instrument constitutes "security").

160. *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975) (Congress intended application of federal securities laws to depend on economic realities of transaction because securities are economic transactions).

161. *See id.* at 852. In *Forman*, the Court concluded that the basic test whether a transaction is an "investment contract" or "an instrument commonly known as a security" was the *Howey* economic realities test. *Id.; see also* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946) ("investment contract" is investment in common enterprise with expectation of profits from efforts of others).

162. *See* 421 U.S. at 852. The Court in *Forman* stated that the *Howey* economic realities test embodied the essential attributes that ran through all of the Supreme Court's decisions defining a security. *Id.* The *Forman* Court concluded that a security was an investment in a common venture premised on a reasonable expectation of profits derived from the entrepreneurial or managerial efforts of others. *Id.*

163. *See* Golden v. Garafalo, 678 F.2d 1139, 1148 (1982) (Lumbard, J., dissenting) (*Forman* Court applied two-part test only in response to alternate grounds for Second Circuit's holding); *see also* Thompson, *supra* note 7, at 246. Thompson maintained that attempts by some courts to read a separate test rationale into the structure of the *Forman* opinion constitutes an overreading of the *Forman* structure. *Id.* The *Forman* Court merely considered in turn each of the lower court's alternative holdings and found neither persuasive. *Id.; see* Forman v. Commmunity Services, Inc., 500 F.2d 1246, 1250-55 (2d Cir. 1974) (share in housing corporation is both "stock" and "investment contract").

164. *See infra* note 165.

165. *See* Golden v. Garafalo, 678 F.2d 1139, 1144 (1982) (*Forman* applied two-part test to determine whether instrument is "security" under '33 and '34 Acts); Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.) (*Forman* two-part test determines whether instrument is security), *cert. denied*, 444 U.S. 868 (1979).

166. *See infra* note 167.

a security and that the shares were an investment contract under the *Howey* economic realities test.[167]

The Supreme Court in *Weaver* again rejected a literal approach to defining a security by denying the protections of the federal securities laws to a federally insured bank certificate of deposit.[168] Examining the '33 and '34 Acts' definition of a security, the *Weaver* Court stated that an instrument is not a security if "the context otherwise requires."[169] By interpreting the prefatory "context" clause of the federal statutes' definition of a security to mean the surrounding factual circumstances, the *Weaver* court found that the economic context surrounding the purchase of a bank certificate of deposit removed the instrument from the literal definition of a security.[170]

The legislative history of the federal securities laws provides support for the sale of business doctrine.[171] Congress enacted the '33 and '34 Acts to protect investors, not entrepreneurs.[172] Investors need the protections of the federal securities laws to guarantee that public corporations provide individuals with information necessary to make investment decisions.[173] Entrepreneurs, however, do not need the protection of the federal securities laws because entrepreneurs have access to information material to the purchase of a business.[174] The sale

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167. *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848-58 (1975). The *Forman* Court examined the economic realities underlying the housing "stock" transactions in both parts of the Court's response to the lower court's alternative holdings. *Id.* When turning to the Second Circuit's second alternative holding that the housing stock was an investment contract, the *Forman* Court stated that ". . . we *again* must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties." *Id.* at 851-52 (emphasis added). The *Forman* Court's language reveals that the court applied the *Howey* economic realities test to the housing stock in both parts of the Court's holding. *Id.*

168. *See* Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (bank certificate of deposit not security); *see also* Sutter v. Groen, 687 F.2d 197, 200-01 (7th Cir. 1982) (*Weaver* provides solid support for sale of business doctrine); *supra* notes 112-26 and accompanying text (*Sutter* court's conclusion that *Weaver* removed type of note from protection of federal securities laws).

169. *See* 455 U.S. at 558-59 (instrument not security if context requires otherwise); *see also* Sutter v. Groen, 687 F.2d 197, 200 (7th Cir. 1982) (*Weaver* Court removed certificate of deposit from protection of securities laws by relying on "context" clause prefacing federal securities laws' definition of "security").

170. *See* 455 U.S. at 558-59 (bank certificate of deposit not security because regulatory structure of banking industry provides economic context which excludes instrument from securities laws' coverage).

171. *See supra* note 3 (outlining legislative history of '33 and '34 Acts).

172. *See* S. REP. No. 37, 73d Cong., 1st Sess. (1933) (purpose of '33 Act to inform investor of facts concerning securities for sale and to protect investor from fraud and misrepresentation); H.R. REP. No. 1383, 73d Cong., 2d Sess. 1-2 (1934) (purpose of '34 Act to regulate operations of exchanges dealing in securities and commodities for protection of investors).

173. *See* L. LOSS, SECURITIES REGULATION 121-28, 2270-75 (2d ed. 1961 & Supp. 1969) (examining philosophy of disclosure underlying enactment of federal securities laws).

174. *Cf.* Securities Act Release No. 5487 (Apr. 23, 1974). Under § 4(2) of the '33 Act, issuers are exempt from registration if the offerors have access to the same kind of information that registration would disclose. *Id.* If an offeree is in a position of economic bargaining power that enables an offeree to obtain material information from the issuer, the issuer is exempt from registration under § 4(2). *Id.; see also* SEC v Ralston Purina Co., 346 U.S. 119, 125 (1953) (applicability of § 4(1) of '33 Act depends on whether particular class of persons affected need protection of Act).

of business doctrine recognizes that individuals purchasing a controlling interest in a corporation are entrepreneurs who, because of their bargaining position, have an opportunity to inspect the business and therefore do not need the protection of the '33 and '34 Acts.[175]

Additionally, Congress enacted the '33 and '34 Acts to provide a federal remedy when state remedies were inadequate.[176] Congress, however, did not draft the federal securities laws to preempt state corporation laws or to federalize common law fraud.[177] Entrepreneurs who purchase or sell a business have adequate remedies in common-law fraud and under state corporation laws.[178]

Adoption of the sale of business doctrine comports with the Supreme Court's restriction on availability of federal remedies under the securities laws.[179] Moreover, the sale of business doctrine may alleviate the burden on

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175. *See supra* note 174 (sale of business doctrine exception analogized to § 4(2) registration exemption).

176. *See* L. Loss, *supra* note 173, at 105-07, 2267-68 (examining inadequacies of state securities laws which prompted federal regulation). The basic reason for the inadequacy of state securities regulation is the interstate nature of business. *Id.* at 105. Another reason for the inadequacy of state blue sky laws was ineffective enforcement by the states. *Id.* at 105-06. Finally, some of the state acts are illusory. *Id.* at 106-07. For example, some state blue sky laws are limited severely by exemptions. *Id.; see also* at 64-67 (listing common exemptions from some blue sky laws).

177. *See* 15 U.S.C. § 77p (1982) (§ 16 of '33 Act savings clause); *id.* § 78bb(a) (1982) (§ 28(a) of '34 Act savings clause). Both the '33 Act and the '34 Act save all other rights and remedies existing at law or in equity. *See* 15 U.S.C. § 77p (1982); *id.* § 78bb(a) (1982); *see also* L. Loss, *supra* note 173, at 156 (state common law or statutory remedies are not affected by federal securities laws).

178. *See* Thompson, *supra* note 7, at 241-44 (removing sale of business from purview of federal securities laws returns parties to state court). Thompson argues that to invoke the protection of the securities laws, the purchaser must lack control over the intangible investment. *Id.* at 244. In the sale of a business, however, the purchaser buys a tangible item for the purchaser's own use or consumption. *Id.* Common-law fraud protects the purchaser of a tangible item for use or consumption. *Id.*

179. *See* Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (bank certificate of deposit not security); Aaron v. SEC, 446 U.S. 680, 695, 697 (1980) (scienter required in SEC injunctive actions under rule 10b-5 and § 17(a)(1) of '33 Act); Chiarella v. United States, 445 U.S. 222, 230 (1980) (no duty to disclose nonpublic market information under rule 10b-5 absent relationship of trust or confidence between parties to transaction); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979) (no implied private right of action under § 206 of Investment Advisers Act); Touche Ross & Co. v. Redington, 442 U.S. 560, 569 (1979) (no implied private right of action under § 17(a) of '34 Act); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 570 (1979) (federal securities laws not applicable to noncontributory, compulsory pension plan); Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977) (violation of rule 10b-5 requires proof of either deception or manipulation); Piper v. Chris-Craft Indus., 430 U.S. 1, 41-42 (1977) (defeated tender offeror lacks standing for damages under § 14(e) of Williams Act); TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (standard of materiality under § 14(a) of '34 Act); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-214 (1976) (scienter required in rule 10b-5 damages action); Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 60-65 (1975) (traditional equitable principles determine availability of injunctive relief under § 13(d) of '34 Act); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749-55 (1975) (standing to assert private damages action under rule 10b-5 limited to purchasers or sellers); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 (1975) (housing cooperative shares of "stock" not securities under federal law).

federal courts by withdrawing federal jurisdiction over such claims.[180] Ultimately, the Supreme Court must resolve the controversy surrounding the sale of business doctrine to clarify the scope of protection afforded by the federal securities laws.[181]

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180. *See* King v. Winkler, 673 F.2d 342, 343 (11th Cir. 1982) (action alleging violation of federal securities laws dismissed for lack of subject matter jurisdiction); Fredriksen v. Poloway, 637 F.2d 1147, 1154 (7th Cir.) (same), *cert. denied*, 451 U.S. 1017 (1981); Chandler v. Kew, Inc., 691 F.2d 443, 444 (10th Cir. 1977) (same).

181. *See* Scherk v. Alberto-Culver Co., 417 U.S. 506, 514-15 n.8 (1974) (Court did not express any opinion on question of whether acquisition of three interrelated businesses involving a stock transfer was security transaction within meaning of § 10(b) of '34 Act and SEC rule 10b-5). In the *Scherk* decision, the Supreme Court noted that the petitioner did not assign error nor did the petitioner brief or argue whether the purchase was a security transaction. *Id.* The Supreme Court has declined to review decisions on both sides of the sale of business doctrine issue. *See, e.g.*, Fredriksen v. Poloway, 637 F.2d 1147, 1150-53 (7th Cir.) (accepting sale of business doctrine), *cert. denied* 451 U.S. 1017 (1981); Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.) (rejecting sale of business doctrine), *cert. denied*, 444 U.S. 868 (1979); Occidental Life Ins. Co. v. Pat Ryan & Associates, Inc., 496 F.2d 1255, 1261-63 (4th Cir.) (rejecting sale of business doctrine), *cert. denied*, 419 U.S. 1023 (1974).