The Supreme Court's Literalism And The Definition Of "Security" In The State Courts

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THE SUPREME COURT’S LITERALISM AND THE DEFINITION OF “SECURITY” IN THE STATE COURTS

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KARL SHUMPEI OKAMOTO**

Outline of Contents

I. Introduction and Thesis .................................................. 1044
A. Introduction .................................................................... 1044
B. Thesis ............................................................................ 1046

II. The Rise of Literalism and the Demise of Economic Realities in the Supreme Court’s Definition of “Security” ............ 1048
A. The Economic Realities Approach—An Overview of the Pre-Landreth Decisions ............................................ 1048
B. “Stock” and the Literal Approach—An Analysis of the Landreth Decision .................................................. 1051
C. “Notes” and Reves—Reprise of Economic Realities? .. 1055

III. The Definition of “Security” in the State Courts .............. 1060
A. “Stock” After Landreth in the State Courts .......... 1060
B. “Notes” After Reves in the State Courts .................. 1063
C. The Ongoing Power of Purpose-Based, Economic Realities Tests in the State Courts—The Dominance of Howey ................................................. 1066

IV. A Common-Law Approach for Common-Law Courts .... 1068
A. The Case Against Deference—The Function of Plain Meaning in the Federal Courts ................................ 1068

V. Turning “Investment Contract” Inside Out—General Partnerships and Other Rattlings Inside the Howey Cage........ 1076
A. Labels as Literalism....................................................... 1076
B. The Polar Star—Williamson v. Tucker and Other “Early” Cases ............................................................ 1077
C. Down the Channel Toward Literalism—Truncation of the Three Prong Test to the First Prong............ 1078
D. A Near Free Fall into the Abyss of Literalism—The Ninth Circuit and General Partnership Interests as Investment Contracts ............................................. 1080

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I. INTRODUCTION & THESIS

A. Introduction

The definition of "security" is a threshold issue for the development of both state and federal securities regulation. This is because, in either a federal or state court, the conclusion that a case does not involve a "security" will foreclose application of the relevant securities act. For example, the question of whether or not a state legislature has determined to reverse the common-law rule of caveat emptor for the sale of pyramid investment schemes or oil drilling leases or apple orchard syndications depends on whether these transactions involve a "security." If a "security" is involved, the transaction is subject to the affirmative antifraud protection afforded by the state securities statute. If not, the laissez-faire, common-law rule will apply. One invokes the same analysis to determine if the federal antifraud rule will apply.

It is unremarkable to find that parallel statutes, such as federal and state securities legislation, should both depend on the definition of their common subject matter for their application. The centrality of the definition of "security" is self-evident in either a federal or state version of a securities statute. The point, however, leads one to a second and more interesting

1. See Williamson B.C. Chang, Meaning, Reference, and Reification in the Definition of a Security, 19 U.C. Davis L. Rev. 403, 421 n.92 (1986) (stating that "[t]he very nature of the concept of a security is that it triggers the application of the securities acts").

2. The definition of "security" is found in Section 2(1) of the Securities Act of 1933. 15 U.S.C. § 77b(1) (1988). A very similar definition is also found in Section 3(a)(10) of the Securities Exchange Act of 1934. Id. § 78c(a)(10). The United States Supreme Court has consistently held that the two definitions will be treated as if identical. E.g., Reves v. Ernst & Young, 494 U.S. 56, 61 n.1 (1990); Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985); Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967).


question. Given that both federal and state courts must struggle with the definition of "security" to determine the ambit of the laws, must they reach the same answer?

Most state courts have assumed that the term "security" should have the same meaning under both federal and state law. While couched within different regulatory legislation uttered by different sovereigns, these courts nevertheless concluded that like terms must have like definitions. As a result, these state courts exhibited a strong deference to federal answers, even accepting federal precedent with which they openly disagreed.

This deference to federal law is interesting since securities regulation began as state law. For over two decades before the adoption of the federal regime, the sale and trading of securities were exclusively the subject of state regulation. The area only became a federal issue when Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. In fact it was the state securities statutes, or so-called "blue sky" laws, that provided models for the federal legislation. However, despite their status as the forebearers of the federal statutes, state securities laws have long since taken a back seat to the federal regulation. Although Congress specifically refused to preempt state blue sky laws, the federal legislation has dominated the area. Indeed, in a reversal of roles, the state legislatures now often look to the federal statute as the model for their own legislation.

One principle of the Uniform Securities Act, the predominant model for modern state statutes, is the harmonization of state and federal regulation. The Uniform Securities Act often achieves this end by coordinating with the comparable federal requirements. The most obvious example of harmonizing

3. See cases discussed infra Part III.
4. See cases discussed infra notes 99-110 and accompanying text.
6. The federal statutes, including the definition of "security" upon which most current state statutes are based, was in turn based on prior state legislation. See Louis Loss & Joel Seligman, Securities Regulation 869 n.1 (1989) (stating that "[s]ection 2(1) [of the Securities Act] was modeled on the definitions in some of the state blue sky laws"); Lowenfels & Bromberg, supra note 2, at 488 (noting that "[t]he definition of the term 'security' contained in the 1933 Act was modeled upon earlier definitions in state blue sky laws").
8. We have already seen that the federal definition of "security" has been incorporated into state statutes through the Uniform Securities Act. See discussion supra note 2. Another important example of state law following the federal precedent is the antifraud provision. Section 101 of the Uniform Securities Act, 78 U.L.A. 516 (1985) (last amended in 1958), was expressly modeled after the federal Rule 10b-5, 17 C.F.R. § 240.10b-5 (1992), and Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1988). See Uniform Securities Act (1956) § 101 cmt., 78 U.L.A. 516 (1985).
by coordination is the *Uniform Securities Act*’s provision for registration of new offerings by coordination. ¹⁰ To avoid the inefficiencies of duplicative regulation, issuers whose offerings are registered under the federal securities laws need only file copies of their federal filings with the state authorities and may even obtain automatic state approval as a consequence of federal approval. In these cases, the benefits of harmony are evident. One need only imagine the consequences to corporate finance if each offering required separate and full-blown registration and approval from both federal and numerous state authorities.

The *Uniform Securities Act* is also seen as pursuing harmony when it mimics the federal standards. In these cases, rather than subsume their separate regulatory regimes within the federal scheme, state regulations simply duplicate the federal standards. For example, a state will pattern its antifraud provision on the words of the federal Rule 10b-5.¹¹ It is often assumed that the benefits of uniformity again underlie the parallels between the state and the federal statutes.

Several state courts have viewed the policy of harmonization as a mandate to follow federal court precedent in interpreting similarly phrased provisions in their respective securities acts, including the term “security.”¹² This Article concludes, however, that there are compelling reasons for state courts to reject recent United States Supreme Court precedents in their efforts to define the term “security” and thereby delimit the scope of their own state’s securities act.

### B. Thesis

Focusing specifically on the Court’s textualist or literalist approach to the definition of “security” in *Landreth Timber Co. v. Landreth*¹³ and *Reves v. Ernst & Young*¹⁴ and more generally on its growing refusal to inquire into the economic realities of a given investment scheme to determine the appropriateness of applying the federal securities laws, this Article identifies various institutional issues unique to federal courts as the motivation for the Court’s recent utterances. Whatever the merits of the Court’s concern, the important point for this Article is that such concerns are irrelevant for state courts. By accepting recent Supreme Court precedent as controlling in defining “security,” state courts are importing, without reason, the Supreme Court’s handwringing over its appropriate role within the federal constitutional scheme of government. As traditional common-law courts, the state courts need not anguish in the same way over their attempts to interpret a state statute in a manner which makes sense in light of its purpose. Furthermore, while the

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¹¹. See discussion supra note 8.
¹². See cases discussed infra notes 98 & 136 and accompanying text.
authors accept as a general matter the need for harmonizing the federal and state regulations, this Article rejects that policy when the specific issue is the definition of "security." While the benefits of coordinating filing requirements for securities transactions subject to the dual levels of regulation are obvious, there is no need for uniformity in the scope of federal and state securities statutes. This conclusion stems, admittedly, from the authors' opinion that the state courts have simply done a better job in developing doctrine in this area.

This Article begins with a review of the Supreme Court decisions on the definition of "security." For decades the Supreme Court and the lower federal courts appeared comfortable with a case-by-case analysis of each new investment transaction to determine the appropriateness of invoking the provisions of the federal securities laws. In the mid-1980s this focus on "economic realities" gave way to a pedantic obsession with plain meaning. Under this new literalist approach, whether or not there is any justification for imposing the federal regulatory regime on a transfer of control of a business, if instruments denominated as "stock" are involved, the Court has held itself to be powerless to look beyond the labels and consider the policy of the legislation in determining whether stock is a "security." The Court has adopted a similar presumption that instruments bearing the label "note" are securities. A literal approach to "stock" and "notes" comes at the expense of a deliberative, policy-oriented development of the federal securities laws. Even worse, federal courts have used the label "general partnership" to evade even a factual inquiry into the need for securities law protection in cases involving precisely the type of fraudulent investment scheme one would expect the securities laws to address. Viewed simply from the narrow interests of the wise development of securities law doctrine, little justification exists for the Court's literalist approach in these cases.

This Article argues that the Court should not have rejected an overarching economic realities approach to the scope of the federal securities laws. By viewing the developing standards under the famous Howey test as a movement toward a global standard for identifying "securities" rather than simply the subpart "investment contracts," the Court could have allowed for a more coherent doctrinal development.

15. See discussion infra Part II. A.
16. See discussion infra Part II. B.
17. See discussion infra Part II. C.
18. See infra Part V.
20. See infra notes 252-59 and accompanying text.
Although the authors advocate such a critique, the principal assertion of this Article is that a rejection of the Supreme Court's doctrinal solution is not necessary to the conclusion that state court's should not consider themselves compelled to follow federal precedent. The key to this conclusion is an understanding of the broader context of the Court's new literalist approach. The conclusion that "stock" or "notes" must be literally construed to be "securities" because the text of the statutory definition says so is not a decision made from the narrow perspective of securities law but from the Court's larger concern over statutory interpretation generally, a concern which does not constrain state courts.  

Nevertheless, several state court decisions have followed the Supreme Court precedents despite often overt disagreement with their reasoning. To examine the impact of the Supreme Court's decisions in Landreth and Reves on state courts' interpretation of the term "security," the authors have examined all state court decisions on the definition since 1985. The authors have discovered that whereas state courts have felt compelled to follow the Supreme Court's new literalist approach in the limited cases involving "stock," elsewhere a purpose-based, economic realities approach continues to flourish under state law.  

The authors' conclusion is that this flexible, purpose-based approach should be allowed to encompass even the cases of "stock." Neither deference by the state courts to federal precedent nor a slavish policy of uniformity is warranted. In fact, to misappropriate a metaphor from those who advocate federal deregulation, it is perhaps time again for the federal regime to learn from the laboratories of the states. While the Supreme Court's literalist approach has infiltrated into the state courts, it has not had the same cabinning effect on the economic realities approach as it has had in the federal courts. Therefore, state courts have since 1985 come farther in developing a holistic approach to the definition of "security" and the scope of the securities laws.

II. THE RISE OF LITERALISM AND THE DEMISE OF ECONOMIC REALITIES IN THE SUPREME COURT'S DEFINITION OF "SECURITY"

A. The Economic Realities Approach—An Overview of the Pre-Landreth Decisions

In the "old days," federal courts read the definition of a security broadly, mindful of the remedial purpose of securities regulation.  The Supreme Court
led the courts in this effort. In particular, the Court used "investment contract" to trap novel or uncommon schemes within the securities laws' grasp in whatever form they appeared.

For example, the Court noted in SEC v. Joiner Co.26 that items other than stocks and bonds found to be securities are of a more variable character and were necessarily designated by more descriptive terms, such as "transferable share," "investment contract," and "in general any interest or instrument commonly known as a security." We cannot read out of the statute those general descriptive designations merely because more specific ones may have been used to reach some kinds of documents . . . [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved . . . that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," . . . 27

The Joiner decision was the antithesis of literalism. The Court emphasized the point wherein the investors' "economic interest" focused, not the interest in land, but the prospect of a test well being drilled in the vicinity: "the undertaking to drill a well runs through the whole transaction as the thread upon which everybody's beads were strung."28

SEC v. W.J. Howey Co.29 articulated a connotative definition of investment contract, namely, "a contract, transaction or scheme whereby a person invests money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."30 The Court found that in combination two items not securities, real estate and contracts for services, could become an investment contract:

The term "investment contract" is undefined. . . . But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute and . . . had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality.31

To the Court, an investment contract "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."32

28. Id. at 348.
29. 328 U.S. 293 (1946).
31. Id. at 298, relying on, inter alia, State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920).
32. Id. at 299.
In *Tcherepnin v. Knight* the Court applied an expansive economic realities reading to other items listed in the statutory definition of "security." Savings and loan withdrawable capital shares were securities under expansive readings of "stock," "certificate of interest or participation in any profit sharing agreement," or "investment contract." The Court prefaced its findings with more general remarks:

[W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. . . . Finally, we are reminded that, in searching for the meaning and scope of the word "security" in the Act, form should be disregarded for substance and the emphasis should be on economic reality.4

Lower federal courts became imbued with these nearly somatic sentiments. For example, with economic realities in mind, the federal courts expanded the definition of investment contract to include schemes in which the promoter or third party's efforts were "primarily" or "substantially," as opposed to "solely," responsible for the gains of the venture. And those gains were measured as "any economic benefit" rather than simply traditional profits. In an era of tax shelter investments, the economic benefit refinement was necessary because tax laws gave high bracket taxpayers incentives to purchase investments generating paper losses. As to the former, the courts asked whose efforts were "the undeniably significant ones."33 Otherwise, by requiring nominal efforts on an investor's part, a promoter could escape application of securities laws' registration and antifraud rules.36

*United Housing Foundation, Inc. v. Forman* marks the turning point of the broad investment contract approach. Although literally "stock" and "shares," shares in a low and middle income housing cooperative were held to be neither stock nor an investment contract. Mr. Justice Powell took a 1920s view ill-suited for a world of modern tax shelter schemes. He held that for investment contract purposes "[b]y profits, the Court has meant either

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Some state courts did federal courts one better. They held an item to be a security when the investment of money in a common enterprise produced a social or recreational rather than an economic benefit. Or at least that was true when the investment constituted the very "risk capital" of the venture. In that instance, the increased risk that the golf course, or recreational real estate facility, or tennis club might never be built justified application of the securities laws. *See Silver Hills Country Club v. Sobieski*, 361 P.2d 906 (Cal. 1961) (Traynor, J.). Another early case is *State v. Hawaii Market Center, Inc.*, 485 P.2d 105 (Haw. 1971). These state court decisions in turn influenced the federal courts. *See discussion infra notes 267-68 and accompanying text.
capital appreciation . . . or a participation in earnings. . . .” He rejected an argument that a promoter's structure for a transaction, a structure that produced favorable tax treatment, could be the "efforts of others" leading to a finding of investment contract.

Overall, however, Justice Powell rejected any literal approach:

We reject at the outset any suggestion that the present transaction . . . must be considered a security transaction simply because the statutory definition of a security included the words "any . . . stock."

Respondents' reliance on Joiner as support for a "literal approach" to defining a security is misplaced.

In holding that the name given to an instrument is not wholly dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply.

Forman is a case filled with doctrinal difficulties. For example, introducing purchaser's intent inserted a subjective element into the objective process of determining the presence of the various elements of the investment contract definition. Mr. Justice Powell's antiquated view of profits, and substitution of his view for the "any economic benefit" approach that had been evolving, was also overly restrictive and capable of causing mischief in the lower courts. Fortunately, the lower courts did not adopt this restricted view and allow tax shelter investment schemes to escape securities law coverage.

For over thirty years, though, through Joiner, Howey, Tcherepnin, and Forman, the Supreme Court's emphasis had been the same—economic realities and the remedial purposes of the securities laws. The Court, followed by lower courts, maintained that focus by using a broad application of the investment contract definition, both as a primary tool and as a crosscheck when litigation involved substantial issues involving application of items specifically enumerated in the statutory list.

B. "Stock" and the Literal Approach—An Analysis of the Landreth Decision

The Supreme Court's articulation of an economic realities approach in Forman became the basis for the so-called "sale of business" doctrine.41

39. See id. at 855 & n.20 (reasoning that "[e]ven if these tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others").
40. Id. at 848-50.
41. For a detailed discussion of the development of the "sale of business" doctrine, see
Under that doctrine, sales of stock effected as part of "negotiated transactions involving the sale of control of a business" were not held to be subject to the securities laws. Although involving "stock," an instrument explicitly included within the literal definition of "security," courts refused to adopt a literal reading and instead adopted an economic realities approach.

Using an economic realities approach, courts and commentators reasoned that the securities laws should not apply to transactions involving a transfer of a controlling interest to a party intending to participate actively in the ownership and management of the company. Regulatory intervention was not necessary because such a purchaser was expected to have sufficient bargaining power to protect herself. Furthermore, it was arbitrary for the securities laws to apply when such control transactions were structured as stock sales, and not when structured as asset sales. This elevated form over substance.

The United States Supreme Court's decisions in *Landreth Timber Co. v. Landreth* and *Gould v. Ruefenacht* rejected this economic realities analysis and instead adopted a literal approach. In *Landreth*, the Court refused to uphold the "sale of business" doctrine and allowed the purchaser of one hundred percent of the stock of a privately-held business to sue the seller for

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43. See, e.g., Frederiksen v. Poloway, 637 F.2d 1147, 1150-51 (7th Cir. 1981). *But see Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982) (refusing to examine economic realities in face of literal application of statute to stock).


45. *Landreth*, 471 U.S. at 698 (Stevens, J., dissenting) (stating that "I believe that Congress wanted to protect investors who do not have access to inside information and who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties"); Easley, *supra* note 41, at 967-68 (suggesting that when parties have equal bargaining power, investor is shielded by "self-interest").

46. *Landreth*, 471 U.S. at 699 (Stevens, J., dissenting) (stating that "it is only a matter of interest to the parties whether the transaction takes the form of a sale of stock or a sale of assets and the decision usually hinges on matters that are irrelevant to the federal securities laws. . ."); Carney, *supra* note 44, at 370-71 (finding no meaningful distinction between stock and asset sales). *But see Dennis S. Karjala, Realigning Federal and State Roles in Securities Regulation Through the Definition of a Security*, 1982 U. Ill. L. Rev. 413, 426 (arguing that purchase of stock requires greater protection since investigation of enterprise is more difficult than examination of assets).


a sale without registration and for material misrepresentations and omissions under the federal securities laws. *Gould* was a similar case, involving, however, the transfer of only fifty percent of the outstanding stock of a privately-held business. In rejecting the "sale of business" doctrine and its underlying economic realities approach, the Court stated that "where an instrument bears the label 'stock' and possesses all of the characteristics typically associated with stock . . ., a court will not be required to look beyond the character of the instrument to the economic substance of the transaction to determine whether the stock is a 'security' within the meaning of the Acts." Therefore, the Court concluded, "the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts."^49

Literalism prevailed over economic realities. However, unlike the more strident literalist opinions of recent vintage,^51 the Court attempted to vindicate its plain meaning interpretation by reference to legislative intent and to policy considerations. Although there are several aspects to the policy discussions in the opinion, one central theme stands out. To the Court, the public expectation that an instrument denominated as "stock" will be subject to the securities laws justifies a literal approach to stock. As the Court stated, "traditional stock 'represents to many people, both trained and untrained in business matters, the paradigm of a security.' . . . Thus persons trading in traditional stock have a high expectation that their activities are governed by the Acts."^54

It is questionable, however, whether this same public expectation holds true in the context of a privately negotiated transfer of control. Furthermore, whether or not there was such an expectation, following the *Landreth* decision, parties are now *required* to accept an antifraud warranty into their transaction if structured as a sale of stock. The mandatory application of the antifraud

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51. Professor Eskridge has identified a trend from a "soft" plain meaning approach, where the Court invoked traditional arguments of legislative intent and policy to buttress its plain meaning interpretations, to a "harder" plain meaning rule, in which the Court refuses to go beyond the words at all. See *William N. Eskridge, Jr., The New Textualism*, 37 UCLA L. Rev. 621 (1990).

52. Another mollifying aspect is the Court's attempt to accommodate the *Forman* opinion into its literalist approach. As we shall see in Part V., *infra*, in the case of general partnerships, some federal courts have taken literalism to justify a refusal to go beyond the label given to the instrument in question by the parties. The Court in *Landreth*, however, held that a court must still determine whether an instrument is what it purports to be before the literal application of the securities laws to such type of instrument will ensue. See *Landreth*, 471 U.S. at 686-87.

53. For a discussion and critique of several other aspects of the decision, see Lawrence Page, Note, *Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security*, 1992 U. Ill. L. Rev. 249, 278-88.

rule will at times conflict with private preferences, and thus impose an inefficiency. This inefficiency becomes evident upon a critical examination of the assumption that any party to a stock sale will expect to have available the antifraud remedy under the federal securities laws. Remembering that the buyer of an asset with warranties must pay more than one who purchases the asset on an "as is, where is" basis, it is easy to imagine a buyer who would prefer to forego a warranty because of its cost. The mandatory application of the antifraud warranty to all stock transactions imposes this cost despite the preference, thus creating the inefficiency. Regulatory interference with private preferences is generally discouraged and must be justified.

The Supreme Court offered a justification based on predictability. The linchpin to application of the "sale of business" doctrine is a determination that the stock sale was effected as part of a transfer of control. The Court concluded that the need to determine whether control was being transferred "inevitably would lead to difficult questions of line-drawing." The indeterminacy of the analysis would pose two burdens. First, the Court assumes that an analysis of control will threaten the predictability of application of the federal securities laws, diserving private parties in the planning and negotiation of their transactions. But as we have seen, the clear predictability offered by the Landreth rule comes at the expense of private preference. If, on the other hand, the Court offered an interpretation that allowed private parties to choose whether or not an affirmative antifraud warranty would govern their relationship, predictability would also be served. Under such an approach, the issues would become whether or

55. But see Prentice & Roszkowski, supra note 19, at 490-91 (arguing that choice of stock sale, instead of other transaction structures, indicates expectation of availability of federal securities laws protection).

56. Such a buyer may have a greater capacity to bear the risk than the seller, and therefore values the warranty less than the premium the seller requires to offer it.

57. The inefficiency arises also in less stark, not all-or-nothing examples since the parties may accept an antifraud warranty but may wish to negotiate its specific terms—such as time periods, materiality definitions, deductibles and maximum recoveries—so that it varies from the warranty imposed under federal law.

Although generally parties may not waive application of the federal securities laws, one commentator has suggested that parties to a negotiated stock sale might avoid application of a federal antifraud warranty by explicitly waiving such a warranty in the agreement of sale, thereby undercutting any claim of reliance by the purchaser necessary to pursue a Rule 10b-5 action. See Easley, supra note 41, at 973-74. Another set of commentators has argued that any party seeking such a waiver should be presumed to be engaging in fraud. See Prentice & Roszkowski, supra note 19, at 517.


61. Such an approach was offered by Judge Posner in Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982). He suggested that the "sale of business" doctrine should presumptively apply if more than fifty percent of a company's stock was being transferred. Id. at 203.
not the private choice should be respected or whether paternalism is warranted. These are precisely the kinds of questions one would expect to occupy a court that is determining the scope of a regulatory statute.

Perhaps the Court's more telling justification comes from the second assumed result of unpredictability in the definition of control, the prospect of "extensive discovery and litigation."\(^{62}\) One clear benefit of a plain meaning approach is its simplicity of application. It asks little of a court in reaching its decision, thus eliminating the need for extensive fact-finding. As shown in Part III. A., this is one explanation for the use of plain meaning by federal courts. It is an explanation that leads the authors to encourage state courts to ignore the federal precedents.

C. "Notes" and Reves—Reprise of Economic Realities?

1. The Early Note Cases. Federal courts have long been troubled by "too many notes," just as was Mozart’s royal patron in Amadeus. The federal courts, however, face a surfeit of notes and problems relating thereto of a thornier sort—promissory notes and the application of securities laws to them.

In its definition of a security, the Securities Act of 1933 flatly includes "any note."\(^{63}\) The Act then exempts from its registration requirements "[a]ny note, draft, bill of exchange, or banker’s acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months . . . ."\(^{64}\) For antifraud rule purposes, however, the Securities Exchange Act of 1934 contains section 10(b), pursuant to which the general antifraud rule, rule 10b-5, has been adopted. That statute's definition of security does not include all notes. The definition provides that, for 1934 Act purposes, notes, drafts or bills of exchange are not securities at all if their maturity at issue does not exceed nine months.\(^{65}\)

This statutory thicket first appealed to poverty lawyers and consumer advocates. Imagine the purchaser of a freezer and refrigerator who had been the victim of a hard sell. She gave a three year installment note and a purchase money security interest in the goods at the time of purchase. Later, when the payments became too onerous, or buyer’s remorse set in, she consulted a clever consumer advocate attorney. He defended the seller’s action with the affirmative defense of securities fraud, alleging that the representations connected to the sale of the goods violated rule 10b-5.

Federal courts had little trouble with those early cases. Judges developed the "commercial-investment dichotomy." If the transaction were commercial

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62. Gould, 471 U.S. at 705. See also Landreth, 471 U.S. at 697.
64. Id. § 77c(a)(3).
the securities laws did not apply. Those federal courts evaded the statute's express inclusion of "note" within the definition of "security" by invoking the "context clause," which prefaces the definitions section of either statute. The context clause states "[w]hen used in this [title], unless the context otherwise requires . . . the term 'security' means any note . . . ."66 The context had to require otherwise. Commercial chaos would result if the securities laws applied to every installment sale of a freezer, refrigerator, boat or pickup truck.

The courts, though, continued to face an ever widening array of "notes." In processing those cases, the commercial-investment dichotomy was not always helpful. The test was conclusory, helpful only at the antipodes, the pickup truck purchase on one antipode, or the three year loan of funds at an attractive rate of interest at the other. Some courts, though, continued to use the commercial-investment dichotomy, calling them as they saw them.67 Other courts, most notably the Second Circuit, developed what it called the "family resemblance test."68 Still other courts found application of the Howey investment contract test to be the most analytically helpful.69

2. Attempted Resolution by the Supreme Court. In Reves v. Ernst & Young,70 Mr. Justice Marshall attempted to resolve this split among the circuits. The Farmers' Cooperative of Arkansas and Oklahoma newsletter offered to the Co-Op's 23,000 members, and other readers as well, uncollateralized and uninsured demand promissory notes. The notes' attractive feature was that they carried a variable rate of interest that the Co-Op adjusted monthly to keep the rate higher than the rate of local financial institutions. Some 1600 persons chose the Co-Op notes as convenient places to park $10 million in funds.71 When the Co-Op entered bankruptcy, note holders sued the auditors, Ernst & Young, for aiding and abetting securities fraud. The Eighth Circuit rejected their claim, finding that "[t]he demand nature of the notes is very uncharacteristic of a security."72 The court found that the virtually instant liquidity a demand note affords was inconsistent with the long term risk ordinarily associated with a security.73

At the outset, Mr. Justice Marshall rejected application of the Howey test. "To hold that a 'note' is not a 'security' unless it meets a [catchall] test

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67. See, e.g., Baurer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981); American Fletcher Mortgage Co. v. United States Steel Credit Corp., 635 F.2d 1247 (7th Cir. 1980); United Am. Bank of Nashville v. Gunter, 620 F.2d 1108 (5th Cir. 1980).


69. See, e.g., Union Nat'l Bank of Little Rock v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986).


73. See Arthur Young, 856 F.2d at 54.
designed for an entirely different variety of instrument," he concluded, "would make the Acts' enumeration of many types of instruments superfluous."74 Of course, thirty, forty and nearly fifty years before the Court had held the opposite. In SEC v. Joiner, the Court held that "[w]e cannot read out of the statute [those] general descriptive designations merely because more specific ones have been used to reach some kinds of documents,"75 and in Tcherepnin v. Knight the Court applied an investment contract Howey analysis to an item listed in the statutory definition as "stock."76

The Reves opinion then read out the "investment versus commercial" test as essentially the same as the "family resemblance" test it thereafter chose to decree for lower federal courts. "A note is presumed to be a 'security'" under the family resemblance test, "and that presumption may be rebutted only by showing that the note bears a strong family resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument."77 The categories of instrument clearly commercial include ""the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, the short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes open-account indebtedness incurred in the ordinary course of business . . ."?78

Four factors are to enable courts to determine whether novel or uncommon notes bear a family resemblance to the enumerated items. Those factors are indicated by Mr. Justice Marshall's stream of consciousness analysis:

First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash flow difficulties, or to advance some other commercial or consumer purpose . . . the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument . . . Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction

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74. Reves, 494 U.S. at 64 (quoting Landreth v. Landreth Timber, 471 U.S. 681, 692 (1985)).
75. 320 U.S. 344, 351 (1943).
77. Reves, 494 U.S. at 67.
78. Id. at 65 (quoting Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976) (Friendly, J.)).
might suggest that the instruments are not "securities". Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.\textsuperscript{79}

Applying the four factors, Mr. Justice Marshall found the Arkansas Oklahoma Co-Op notes to be securities.\textsuperscript{80}

3. \textit{Reves—A Reprise of Economic Realities?} Although Mr. Justice Marshall took pains to reject application of investment contract analysis,\textsuperscript{81} what he wrought is very similar to the investment contract \textit{Howey} analysis as it has evolved. His first factor is "motivations that would prompt a reasonable seller and buyer."\textsuperscript{82} Motivation of the seller, of course, is not helpful because it is a constant one of obtaining the use of other people's money. The buyer's motivation, though, can vary, principally between consumption or investment. The first \textit{Howey} element, of course, is "an investment of money."\textsuperscript{83} As has been seen,\textsuperscript{84} \textit{United Housing Foundation, Inc. v. Forman} highlighted motivation as the crux of the economic realities approach. If the buyer's motivation is consumption—of housing, or of a refrigerator, or of a pickup truck—rather than investment, the package or item offered is not an investment contract and therefore not a security.

Commentators have also divined in Mr. Justice Marshall's second element, the "plan of distribution," a cousin or sibling of the investment contract commonality requirement:

This second factor resembles the second prong of the \textit{Howey} test: the commonality/multiplicity requirement. Both distinguish between the loan-type transactions in which the investor has the bargaining power to protect him- or herself in the contract from schemes in which the investor's bargaining power is diluted by the presence of other similarly situated investors.\textsuperscript{85}

\textbf{Footnotes:}

79. Id. at 66-67 (citations omitted).

80. Fortunately, Mr. Justice Marshall rejected the approach espoused by Chief Justice Rehnquist, which can only be characterized as literalism at its worst. In his concurring opinion, predictably joined in by Justice Scalia, the Chief Justice cited some older cases holding that a demand promissory note is for statute of limitations purposes, due upon issue. \textit{See id. at 77} (Rehnquist, C.J., concurring in part and dissenting in part). Due upon issue means a maturity of less than nine months. Since the Securities Act of 1934 excludes altogether from its definition of a security notes with maturities of less than nine months, the Chief Justice would have afforded no relief in the case. \textit{Id. at 81-82}.

The opinion reflects not mere total reliance on labels alone, literalism, but literalism at its worst, reliance on labels alone to further an unstated agenda. That agenda, of course, dating from \textit{Blue Chip Stamps v. Manor Drug Stores}, 421 U.S. 723 (1975) (Rehnquist, J.), has been to use every opportunity to decide securities cases for defendants and, in doing so, to prune back ever more severely the reach and protection of the securities laws.

81. \textit{Reves}, 494 U.S. at 64.

82. \textit{Id.} at 66.


84. \textit{See supra} notes 37-40 and accompanying text.

The third Marshall factor, the "reasonable expectations of the investing public," seems similar to the first. If the reasonable person would expect the protections of the securities laws to apply, the factor tips the transaction toward a finding of security. On the other hand, as Forman taught, if the motivation is housing, or some other consumption animus, then the reasonable investor would not expect the securities laws' protection. The balance tips the opposite way.

Finally, Mr. Justice Marshall asks whether in the context in which the note appears there exists some risk reducing factor "such as the existence of another regulatory scheme." International Brotherhood of Teamsters v. Daniel introduced this refinement to investment contract analysis, noting that the Employment Retirement Income Security Act (ERISA) weighed against finding an involuntary, noncontributory pension plan interest to be a security. Later, Marine Bank v. Weaver amplified this new factor. Marine Bank noted the presence of depository insurance in a case involving a certificate of deposit. Ultimately, the Court found no investment contract and no security present.

The difficulty with Reves is that the similarity to Howey is not crystal clear. Just enough dissonance exists between the two approaches that lower courts will continue to regard "investment contract" and promissory note analyses as separate tracks. On a theoretical level, Reves will join Landreth Timber as another obstacle to the development of an overall general working definition of a security—what one commentator labels a "connotative definition of a security." On the other hand, all the commentators who have closely examined Reves and its four factors see in the analysis a reworked or rephrased distillation of the Howey test. Those observations prove that a "connotative"

86. Reves, 494 U.S. at 67.
89. 455 U.S. 551 (1982).
91. See, e.g., Page, supra note 53, at 250 (recognizing that "the Supreme court has stumbled into a line of analysis that not only muddies the concept of a security under the securities laws, but also does not provide the guidance necessary to accurately identify a security in a case involving anything more than an easily identifiable instrument at either extreme"); id. at 288 (finding that in Reves "the Court unfortunately announced an unpredictable test" and "jumbled and misapplied the Howey elements").
92. See id. at 299.
93. See, e.g., James D. Gordon III, Interplanetary Intelligence About Promissory Notes as Securities, 69 Tex. L. Rev. 383, 394 (1990) (suggesting it is not so clear that tests for notes and for investment contracts are different); Marc. I Steinberg, Notes as Securities: Reves and Its Implications, 51 Ohio St. L.J. 675, 679 (1990) (stating that "an argument can certainly be made that the Howey and 'family resemblance' tests are quite similar"); Leonard J. De Pasquale, Comment, Helping to Ameliorate the Doctrine of Caveat Emptor in the Securities Market: Reves v. Ernst & Young, 26 New Eng. L. Rev. 893, 908-09 (1992) (noting that "[i]n adopting the 'family resemblance test' the Court persisted with its philosophy of examining the economic realities of an instrument"). Page, supra note 53, at 290-91 comes to the same conclusion.
definition lurks in the depths and that the definition is the investment contract one. Investment contract analysis and Howey are means of probing economic realities. They are commended to state judiciaries as the tool for doing so. On the state level, no Landreth or other obstacle blocks the path toward evolution of an overall definition of a security. Reves v. Ernst & Young demonstrates that point.

III. THE DEFINITION OF "SECURITY" IN THE STATE COURTS

A. "Stock" After Landreth in the State Courts

With few exceptions, since the United States Supreme Court's decisions in Landreth Timber Co. v. Landreth and Gould v. Ruefenacht, state courts have joined in the rejection of the "sale of business" doctrine and applied their state securities laws whenever a transaction involves stock. The courts have explained that the policy of coordination mandates adopting the Supreme Court's literal approach. This policy of harmony has outweighed even strong

94. We have found only two state court opinions which have upheld the "sale of business" doctrine and rejected a literal application of a state securities statute to a transaction involving stock. Cook v. Wills, 808 S.W.2d 758 (Ark. 1991) (applying combination of investment contract and risk capital analysis to conclude that large block investment in closely-held company imparted control, thus precluding finding of "security"); White v. Solomon, 732 P.2d 1389 (N.M. Ct. App. 1986) (following as persuasive federal circuit court cases upholding "sale of business" doctrine). Neither opinion indicates an awareness of the Supreme Court's opinions in Landreth or Gould.

An intermediate appellate court in Georgia attempted an end run around the Supreme Court holdings. In Henderson v. KMSystems, Inc., 374 S.E.2d 550 (Ga. Ct. App. 1988), the court refused to apply the state securities act to the repurchase by the corporation of the stock held by a 25% stockholder/employee. Although the court acknowledged that under the Landreth rationale, the act would literally apply to "stock," it went on to hold that the court must first determine if what the parties denominated as "stock" truly possessed the characteristics typically associated with stock. Id. at 552-53. The court concluded that the fact that the stock in the case was legended and therefore non-negotiable meant that it was no longer the kind of "stock" which was intended to be included in the concept of "security." Id. at 553. The Georgia Supreme Court ultimately overruled this sophistic evasion of the Supreme Court's reasoning. Cohen v. William Goldberg & Co., 423 S.E.2d 231, 234 (Ga. 1992) (holding that "Limitations on the transfer of stock in close corporations are common, but neither the small size of the corporation nor the restrictions on transferability remove such a corporation's stock from the reach of [the securities act]").

97. E.g., Banton v. Hackney, 557 So. 2d 807 (Ala. 1990) (recognizing that state securities act applies to sale of all stock of closely-held corporation); Cohen, 423 S.E.2d at 231 (same); Kovatovich v. Barnett, 406 N.W.2d 516 (Minn. 1987) (finding repurchase of stock from 40% shareholder/employee subject to state securities laws); Specialized Tours, Inc. v. Hagen, 392 N.W.2d 520 (Minn. 1986) (holding that state securities act applies to sale of 100% of private company's stock); Barnes v. Sunderman, 453 N.W.2d 793 (N.D. 1990) (holding that state securities act applies to sale of 50% of closely-held company's stock).
98. Kovatovich, 406 N.W.2d at 518 (stating that "we are required to coordinate our interpretation of state securities laws with its federal equivalent"); Specialized Tours, Inc., 392 N.W.2d at 535 (same); Barnes, 453 N.W.2d at 796 (same).
and specifically articulated disagreement with the Supreme Court's decisions. For example, in a decision by the North Dakota Supreme Court in which the court held that the state securities act would apply to the purchase of a fifty percent interest in the stock of a closely-held corporation but found no actionable misrepresentation, a concurring opinion expressly challenged the logic of the United States Supreme Court's rejection of the "sale of business" doctrine. The judge stated he could "divine no rational reason for distinguishing between the transfer of a business which has been incorporated and one which is owned by an individual or partnership who have not incorporated insofar as a fraudulent intent is concerned." As previously discussed, the lack of a meaningful distinction between stock and asset sales is a recurring criticism of the Supreme Court's literal approach to stock as a security. Addressing the policy of coordination, the judge redefined the court's mission not in terms of harmonization but in terms of divining the legislative intent of the state legislature in adopting the state securities act. Therefore, federal law, as in effect at the time the federal statute was used as a model for the state enactment, is persuasive authority; subsequent interpretations of the federal model are not. Taken to its extreme, this argument sees the state act as frozen in time, unaffected by an evolving law of securities regulation. Taken more generously, however, it is a somewhat facile attempt to liberate the state court from its self-imposed servitude to federal law.

The Supreme Court of Minnesota has also openly chaffed under the federal precedents. In an en banc opinion rejecting the "sale of business" doctrine, the court wrote:

Strong legal arguments and sound policy considerations support application of the economic reality or sale of business test in Minnesota, and were we writing on a clean slate, we would do so. However, since the time this case was briefed in this court, the United States Supreme Court has rejected the sale of business doctrine in *Landreth Timber Co. v. Landreth* ... and the companion case of *Gould v. Ruefenacht* ... Because of this state's statutory policy mandating coordination of interpretation of the Minnesota Securities Act with related federal regulations and interpretations ..., we now feel constrained to follow those federal cases.

The court expressed its support for the "sale of business" doctrine in two footnotes. In one, the court gave the following list of legal arguments and policy considerations which support the doctrine:

100. Id.
101. See supra note 46 and accompanying text.
103. Id.
104. Specialized Tours, Inc. v. Hagen, 392 N.W.2d 520, 535 (Minn. 1985) (footnotes omitted).
For example, (1) the "unless the context otherwise requires" language in [the statute] permits a construction that the act does not apply to the sale of a business through a stock transfer when the stock is merely a method of vesting ownership and not the sale of an investment instrument; (2) a holding that a sale of 100 percent of the stock in a business is the sale of a security, while the sale of 100 percent of the assets in a business is not, exalts form over substance; (3) a purchaser of 100 percent of stock in a negotiated face-to-face transaction does not need the protection of the Minnesota Securities Act because the antifraud provisions most often implicated in "sale of business" cases can be written into the sales agreement . . . ; (4) adequate and parallel state common law causes of action exist to give a remedy for fraud and misrepresentation claims; and (5) most parties to a sale of a business through a 100 percent stock transfer would never contemplate that the Minnesota Securities Act would apply to that type of transaction.105

In a second footnote the court approvingly discussed Justice Stevens' dissents in *Landreth* and *Gould*.106 The court made a particular note of Justice Stevens' view that Congress could not have intended the federal securities laws "...to govern the private sale of a substantial ownership interest in these operating businesses simply because the transactions were structured as sales of stock instead of assets."107 The opinion later asserted the same point concerning the intent of the Minnesota legislature. "We question whether the legislature intended, or even contemplated, a result that, even in the absence of an intent to defraud, would burden the seller with such punitive-like liability damages."108 Nevertheless, despite its open critique of the Supreme Court's rulings, its doubts as to the legislative intent of the body that adopted the statute, and even its conclusion that "application of the act leads to an inequitable result,"109 the court followed the federal rule.110

A Washington court has also rejected the "sale of business" doctrine and applied the state securities act to a private sale of one hundred percent of the stock of a small business.111 However, unlike the cases noted above that followed federal interpretations, a 1973 decision from the Washington Supreme Court holding that the state act applied to face-to-face negotiations outside the securities markets for the sale of stock of a closely-held corporation was the basis of the Washington court decision.112 In a subsequent decision

105. *Id.* at 535 n.12.
106. *Id.* at 535 n.13.
107. *Id.* (quoting *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 700 (Stevens, J., dissenting)).
108. *Id.* at 535 n.14.
109. *Id.* at 535.
110. *Id.* And felt constrained to do so again the following year. *Kovatovich v. Barnett*, 406 N.W.2d 516, 518 (Minn. 1987).
112. *Id.* at 181 (citing *Clausing v. DeHart*, 515 P.2d 982 (Wash. 1973)).
involving a limited partnership interest, the court reexamined the earlier Washington Supreme Court decision. Although the court had reviewed federal precedents to determine that the limited partnership interest was not a security because of the extent of the limited partner's practical control of the venture, it nevertheless decided that the conclusion under federal law might not be determinative under state law because earlier state court decisions evidenced a different purpose for the state statute. The court suggested that the state law's different purpose—greater focus on investor protection—would allow application of the statute even in privately negotiated transactions. Thus, even though the result of the state courts is the same, the Washington court's decision to reject the "sale of business" doctrine is different from the other state courts'. Whether or not one agrees with the substantive policy of applying the securities laws to privately negotiated sales of businesses, the basis for the decision—the state's policy—was correct. The basis for decision in the other state courts—a policy of harmonization with federal decisions—was not.

B. "Notes" After Reves in the State Courts

State courts did not extend the logic of Landreth to transactions involving notes. Although, like "stock," "notes" are specifically included in the definition of "security" in state securities acts, the courts eschewed a literal approach and instead approached each case with some version of an economic realities test. For example, the California Supreme Court reversed a lower court's literal application of the state securities laws to a transaction involving notes given to an employee/investor. The court wrote:

The list of instruments which come within the statutory definition of a "security" is an expansive one. However, the cases have adhered to the principle that substance governs over form. "[A] literal interpretation [of the statute] has been uniformly eschewed when to do so would appear to exceed any legitimate legislative purpose." . . . Thus, the "critical question" the courts have sought to resolve in these cases is whether a transaction falls within the regulatory purpose of the law regardless of whether it involves an instrument which comes within the literal language of the statute.

Given this unequivocal rejection of the literal approach, it is peculiar that the court cites Landreth for the proposition that "[t]he high court has recently reaffirmed its commitment to the principle that substance governs over

114. Id.
115. Id.
118. Id. at 694 (quoting People v. Schock, 199 Cal. Rptr. 327, 329 (Cal. Ct. App. 1984)).
form.” Unlike the Supreme Court’s treatment of stock in *Landreth*, the California high court remanded the case for a determination of whether the note involved was a security under an economic realities test similar to the traditional *Howey* analysis.

The rejection of a literal approach was pervasive in the state courts. The post-*Landreth* decisions regarding notes in the state courts reflect the same melange of purpose-based, economic realities tests that was found in the federal appellate opinions. As noted by the Court in *Reves*, the Circuit Courts were following four different versions of an economic realities test—1) the “investment” versus “commercial” dichotomy test; 2) the “family resemblance” test; 3) the *Howey* test; and 4) the risk capital test. Examples of each approach are found in state court decisions since 1985.

The First, Third, Fifth, Seventh, and Tenth Circuits adopted the “investment/commercial” test. State courts in Delaware, Michigan, and Minnesota have followed this approach as well. The Second Circuit produced the “family resemblance” test which a Massachusetts court followed. Despite the explicit statements by the Court in *Landreth* limiting the *Howey* test to investment contracts, the Eight Circuit applied that test to notes in the *Reves* case. Prior to the *Landreth* decision, the District of Columbia Circuit had also applied the *Howey* test to notes, and a number

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119. Id. at 694-95 n.26.
121. See supra Part II. C.
122. Reves v. Ernst & Young, 494 U.S. 56, 63-65 (1990); Loss & Seligman, supra note 6, at 880.
123. Loss & Seligman, supra note 6, at 881 & 881 n.35.
of state courts also took the same approach. Finally, at least two state courts have followed the Ninth Circuit in applying the risk capital test.

With the Supreme Court's decision in Reves, the seeming cacophony of approaches appears to have ended. The state courts have uniformly adopted the Supreme Court's approach. Again the state court opinions cite the same policy of harmonization as the basis for their decisions to follow the federal precedent. There is, however, an important difference between the acceptance of the Reves test for "notes" and the Landreth test for "stock." As discussed above, although the family resemblance test adopted in Reves was described as a "literal" approach, the Supreme Court's opinion actually has more of an economic realities emphasis and seems in fact to sharply circumscribe Landreth's literalist interpretational methodology. For the state courts, at least, the four factor test announced in Reves is similar to the analysis they previously performed under various labels such as Howey, risk capital, or investment/commercial dichotomy. In fact, the state court opi-


133. See Loss & Seligman, supra note 6, at 885-88.


136. E.g., Caucus Distrib., 577 A.2d at 788 (stating that "we consider the interpretation of [the] same term by federal courts"); Chrysler First Fin. Serv. Corp., 1991 Tex. App. Lexis 2534, at *5 (stating that "Texas courts look to federal decisions to interpret the Texas Securities Act"); Saas, 792 P.2d at 555-56 (referring to federal law to determine meaning of "security").

137. See supra notes 81-93 and accompanying text.

138. See Loss & Seligman, supra note 6, at 889; Warren, supra note 134, at 323.

139. In this regard, it is interesting to note the comments made by the one state court which did not follow Reves in a recent case involving notes. In State v. Tober, 826 P.2d 1199 (Ariz. Ct. App. 1991), the court noted the Reves decision but elected to rely on an earlier Ninth Circuit precedent—Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426 (9th Cir. 1978)—which used the risk capital test. Tober, 826 P.2d at 1202 n.5. The court stated: "The United States Supreme Court has recently rejected the Amfac test, adopting the Second Circuit's 'family resemblance' test . . . . Although the Reves test has not been briefed in this matter, we note that we would similarly find sufficient evidence to support defendant's convictions under the Reves test." Id. The court goes on to express its concerns that tests like the Reves test, are unconstitutionally vague, at least in the context of criminal securities law prosecutions. Id. at 1203-05. This is an interesting view of what many see as the most plain meaning of the tests for notes as securities.
nions appear largely to ignore the "literal" portion of the Reves analysis. None invokes either the presumption or the family resemblance list of non-securities in its reasoning. Each opinion immediately turns to the four factor test, allowing the case-by-case, purpose-based aspect of Reves to subsume the vestige of a literal approach. It is therefore not surprising that the state courts have had little difficulty in adopting the new federal rule for notes. They simply are doing what they had done previously.

C. The Ongoing Power of Purpose-Based, Economic Realities Tests in the State Courts—The Dominance of Howey

The state courts' easy assimilation of the Reves decision into their general economic realities approach is not surprising. Harmonization has rarely posed any conflict because state courts have routinely read federal court opinions as supporting their fact-specific, purpose-based approach to application of their state securities laws. For example, in a recent opinion, the Supreme Court of Washington appeared oblivious to the United States Supreme Court's literalist utterances and instead quoted Howey in stating: "The United States Supreme Court has declared that the definition of a security 'embodies a flexible rather than static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits.'”

The Court of Appeals of New York cited Landreth as support for the following decidedly non-literalist statements:

Whether the label of a particular interest and the description given to it by the parties brings it literally within one of the enumerated categories in [the state statute] is not determinative. We must go beyond the "literal test" and—applying a flexible and adaptable approach—"look to the function of [the investment at hand], to search for substance over form with emphasis on economic reality", to see if it displays the characteristics of "securities" in the general sense of the term . . . .

Although the United States Supreme Court may have restricted the economic realities test of Howey to the case of investment contracts, this restriction has had little impact, except in cases involving "stock," on the state courts' enthusiasm for an economic realities approach.

In state courts, an economic realities test such as the four-prong Howey test, or, now in the case of "notes," the four-prong test from the second

140. Cellular Eng'g, Ltd. v. O'Neill, 820 P.2d 941, 946 (Wash. 1991) (quoting SEC V. W.J. Howey Co., 328 U.S. 293, 299 (1946)).

141. All Seasons Resorts, Inc. v. Abrams, 497 N.E.2d 33, 36 (N.Y. 1986) (finding that sale of memberships for nonexclusive use of campgrounds is not security since there is no expectation of profit or other financial gain).


143. See discussion supra Part III. A.
part of the Reves opinion,144 still dominate the inquiry into whether a transaction involves a security.145 The preponderance of "investment contract" cases partly explains the resilience of the Howey test. The simpler cases of stock and notes are less frequently the subject of dispute. The issue of whether the securities laws apply is most often posed when a case involves a novel investment scheme. Schemes found to be securities under the Howey test in recent state court proceedings included such varied investment devices as loan pools,146 pyramid marketing schemes,147 arrangements for gold speculation,148 condominiums,149 franchise agreements,150 partnerships,151 lottery pools,152 oil and gas leases,153 and other miscellaneous "get rich quick" schemes.154 Since none of these schemes falls literally within any of the categories in the definition of "security," more deliberative analysis was required.

However, the sheer number of investment contract cases alone do not explain the continuing vitality of the Howey doctrine. Repeatedly, state courts begin their analysis with the statement that the overriding purpose of the state securities act is to empower the court to protect the defrauded investor. For example, the Kansas Supreme Court began one opinion with the observation: "The purpose of the Kansas Securities Act is to place the traffic of promoting and dealing in speculative securities under rigid governmental regulation and control to protect investors, thereby preventing, so far as possible, the sale of fraudulent and worthless speculative securities."155 Similar

144. See discussion supra Part III. B.

145. In California, the risk capital test appears to have replaced the Howey test as the economic realities test of choice. See, e.g., People ex rel. Christine Bender v. Wind River Mining Project, 269 Cal. Rptr. 106 (Cal. App. Ct. 1990) (holding that sale of "gold production and delivery agreements" to finance new gold recovery method is security under risk capital analysis); People v. Stewart, 227 Cal. Rptr. 275 (Cal. App. 1986) (holding that fraudulent sale of discounted accounts receivable to finance gold mine venture is security under risk capital test).


151. See cases discussed infra Part V. G.


statements of the courts’ focus on investor protection are found throughout the decision. Commentators have compared this state court focus on the individual investor with a perceived focus in federal courts on system-wide market integrity and a growing antagonism to private litigation to vindicate individual harm. The contrast between the state courts’ emphasis on the individual investor and the federal focus is illuminating.

If a court views itself as a forum for adjudicating claims by private parties that were defrauded by an investment scheme which, because of both the passivity and lack of sophistication expected on the part of the investor, requires the heightened protection of the state securities laws, we would expect a preference for flexible analyses. Just as it does in a conventional tort or contract dispute, the court, exercising its common-law function, renders justice in the case at hand. In that setting, bright-line tests such as a literal approach are suspect; they too often yield absurd results in the individual case. Where, however, the import of the issue of defining “security” is more concerned with issues unrelated to individual justice, a literalist approach may be preferred.

IV. A COMMON-LAW APPROACH FOR COMMON-LAW COURTS

A. The Case Against Deference—The Function of Plain Meaning in the Federal Courts

The Supreme Court’s adoption of a literalist approach to the definition of “security” is part of a larger movement in its jurisprudence of statutory

156. E.g., Probst v. State, 807 P.2d 279, 288 (Okla. Crim. App. 1991) (Lane, J., concurring) (stating that “[t]his analysis squares with the purpose of the State Securities Act which is to protect people from schemes . . . which defraud the public”); Shinn v. Thrust IV, Inc., 786 P.2d 285, 298 (Wash. Ct. App. 1990) (stating that “while the purpose of federal securities laws is to maintain the integrity of the secondary securities markets and to enforce disclosure, the state act is intended to protect investors”) (quoting Haberman v. WPPSS, 744 P.2d 1032, 1049 (Wash. 1987)).


158. While this Article seeks in Part IV. A. infra to explain the literalist approach in the federal courts as part of a larger, uniquely federal jurisprudential concern generally associated with Justice Scalia’s textualist methodology for statutory interpretation, there is another, somewhat related distinction between the function of the term “security” in the state and federal regimes. While private rights of action under the federal securities statutes have been firmly established, Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) (“The existence of this implied remedy is simply beyond peradventure.”), they are creatures of judicial making. As written, the federal securities laws do not provide a general private right of action for securities fraud. Therefore, the function of the definition was primarily to establish the jurisdiction of the Securities and Exchange Commission. Although state statutes also empower local securities administrators, the jurisdictional function of the definition is not as important as in the federal regime. This distinction might be of only historical interest since private access to the statute’s remedies is now the dominant concern in both federal and state courts. In this regard, it is interesting to note the Court’s discussion of the implied right of action under Rule 10b-5 in Landreth. Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 n.7 (1985).
interpretation. Although long a part of the Court's arsenal of interpretive tools, the plain meaning approach took on a new importance in the 1980s. Literalism is the most recent response to the Court's lifelong struggle with its proper role in our constitutional system of government. It is an answer to the Court's questioning of the limits of legitimate judicial law-making or common-law powers in the federal system.\textsuperscript{159}

Professor Merrill framed the issue in writing:

The Supreme Court recently declared that "[f]ederal courts, unlike state courts, are not general common-law courts and do not possess a general power to develop and apply their own rules of decision." Almost simultaneously, however, the Court recognized "the need and authority in some limited areas to formulate what has come to be known as 'federal common law.'" Pronouncements to the effect that the common law powers of federal courts are limited or restricted, but that they nevertheless exist in certain circumstances, clearly presuppose some standard or norm for distinguishing legitimate from illegitimate exercises in judicial lawmaking.\textsuperscript{160}

Defining federal common law as all rules pronounced by courts which "are not found on the face of an authoritative federal text,"\textsuperscript{161} Professor Merrill argues for a very restricted common-law power for federal courts. He bases his views on the constitutional principles of federalism, separation of powers and electoral accountability.\textsuperscript{162} These same constitutional concerns are seen as motivating the Court's literalist solution to its question of the legitimate limits to judicial law-making.\textsuperscript{163}

\textsuperscript{159} See Daniel A. Farber, Statutory Interpretation and Legislative Supremacy, 78 Geo. L.J. 281, 289-90 (1989) (criticizing literalism as response to concerns of legislative supremacy); Thomas W. Merrill, The Common Law Powers of Federal Courts, 52 U. Chi. L. Rev. 1, 3 (1985) (suggesting that "federal common law is legitimate insofar as it is the product of textual interpretation"); Cass R. Sunstein, Interpreting Statutes in the Regulatory State, 103 Harv. L. Rev. 405, 415 (1989) (explaining that textualism is device premised on concepts of judicial legitimacy); Note, Intent, Clear Statements, and the Common Law: Statutory Interpretation in the Supreme Court, 95 Harv. L. Rev. 892, 902 (1982) (stating that "the Court in adopting the clear-statement model seeks ... to restore judicial legitimacy by anchoring interpretation in a literalist reading of statutory terms").


\textsuperscript{161} Id. at 7.

\textsuperscript{162} Id. at 3. Professor Merrill also identifies the Rules of Decision Act as a statutory basis for a restriction on judicial law-making. Id. at 27-32.

\textsuperscript{163} Numerous commentators have seen the literalist approach as motivated by one or more of the three constitutional factors identified by Professor Merrill. See, e.g., Farber, supra note 159, at 283 (discussing separation of powers); Sunstein, supra note 159, at 415 (discussing separation of powers and electoral accountability); Note, supra note 159, at 900 (discussing separation of powers).

More recent commentary has focused on Justice Scalia's "new textualism" which Professor Eskridge has labelled a "harder plain meaning rule." See Eskridge, supra note 51, at 656-60
These constitutional concerns which motivate the Court's plain meaning approach are unique to federal courts. These issues are either irrelevant to or have different implications for a state court. Therefore, when a state court blindly follows the Supreme Court's literalist approach to the definition of a "security," it is needlessly assimilating a uniquely federal jurisprudential debate. To see this it is important to consider each of the three articulated constitutional concerns and their applicability to state courts.

The constraint of federalism is based on the constitutional concept of a federal government of limited, enumerated powers contrasted with state governments to whom (along with the body politic) all nonenumerated powers are reserved. To the extent that federal courts exercise expansive common-law powers, they appear to encroach on the reserved powers of the states. A limited textual interpretation preserves state rights because statutes are adopted either within the enumerated powers of the federal government or otherwise with state acquiescence through the states synecdochic participation in the legislative process. Federalism, however, is simply not a concern when considering state court action. As instruments of state government, state courts' use of an expansive common-law approach does not impinge on state rights, and thus there is no constitutional concern.

Unlike federalism, however, separation of powers and electoral accountability as constraints on judicial activism are not unique to federal courts. As one commentator summarized the concern, "In a democratic system, with an electorally accountable legislature and separated powers, it is said to be the appropriate and indeed constitutionally prescribed role of the courts to apply legislative commands; it is thus impermissible for them to invoke considerations that cannot be traced to an authoritative text." This concept of legislative supremacy is a dominant constitutional principle on both the state and federal level. Furthermore, this favoring of the legislative branch in both federal and state regimes is derived from a general philosophy of accountability because this branch is subject to periodic elections. However,

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(describing rise of literalism in Supreme Court as response to Justice Scalia's arguments against use of legislative history). Commentators have identified similar constitutional concerns behind Justice Scalia's advocacy of a textualist or literalist approach to statutory interpretation. See id. at 673-76 (discussing separation of powers); Nicholas S. Zeppos, Justice Scalia's Textualism: the "New" New Legal Process, 12 CARDOZO L. REV. 1597, 1619-20 (1991) (same). Despite the recent association of plain meaning methodology with Justice Scalia, as one commentator has noted, "the use of 'plain meaning' discourse is hardly limited to its most prominent proponent, but is employed by every member of the Court . . . ." Frederick Schauer, Statutory Construction and the Coordinating Function of Plain Meaning, 1990 SUP. CT. REV. 231, 246.

164. See Merrill, supra note 159, at 13-19.
165. Id.
167. Sunstein, supra note 159, at 415.
168. See Farber, supra note 159, at 283; Merrill, supra note 159, at 19-24.
169. See Merrill, supra note 159, at 24.
while relevant to an evaluation of judicial activism in both the federal and state courts, the concepts of separation of powers and electoral accountability have different implications for the different systems.

On the simplest level, electoral accountability concerns are less compelling in the case of state courts since "the overwhelming majority of states require election of judges in some form or another." This electoral accountability should lessen the concerns, at least in some states, for the threat to democratic governance posed by law-making by judges insulated from the popular will through executive appointment and life tenure. However, this distinction does not fully legitimate judicial law-making by state courts. The concept of legislative supremacy is still applicable even to popularly elected judges. Furthermore state constitutions, like the federal analogue, allocate the law-making function to the legislature. The critical difference between state and federal courts lies in the context in which the two types of constitutions function.

As we noted in the discussion of federalism, the federal government is one of enumerated powers. The function of the federal Constitution is to specify those enumerated powers within a context of general law-making powers reserved to the states. The function of state constitutions, on the other hand, is largely to circumscribe the otherwise plenary law-making authority of the state government. This plenary law-making power is vested not only in law-making powers specified for the legislature but also in the traditional common-law powers of the state courts. State courts make law subject to the state legislature's power to modify by statute. This application of the separation of powers concept differs dramatically from the federal scheme where concepts of federalism and limited government require each branch of government to derive its function from the explicit grant of power.

Therefore, the separation of powers concept embodied in the federal Constitution may be seen to dictate a limited role for judicial law-making in light of the explicit delegation of legislative power to the Congress and the subordinated role of courts to legislative enactments when no constitutional concerns are implicated. And, as we have seen, some view literalism as an optimal device to constrain judicial activity within these constitutionally prescribed limits. But in the case of state courts, the separation of powers found in state constitutions does not serve to strip the courts of their traditional common-law powers within a system of shared law-making authority. Therefore, whether acting in an area of legislative silence or legislative ambiguity, it is not objectionable for state courts to make policy subject to legislative veto. Thus, devices to constrain judicial law-making, such as a plain meaning approach to statutory interpretation, are unnecessary, and in

170. Galie, State Supreme Courts, supra note 166, at 108. See also Galie, The Other Supreme Courts, supra note 166, at 791.
171. See Galie, State Supreme Courts, supra note 166, at 104.
172. See Farber, supra note 159, at 283.
173. See id. at 286.
fact contradictory to the state court’s function within state government. 174

Beyond the constitutional motivations for the Supreme Court’s literalist approach, Professor Schauer has identified another institutional motivation which, if true, leads us to argue that not only are state courts free to ignore the Supreme Court’s approach, but that they must. 175 In reviewing the Court’s use of plain meaning in its decisions during the 1989 Term, Professor Schauer posits that plain meaning, although an imperfect device for determining the meaning of any communication, is a “second-best coordinating device for multiple decision makers attempting to reach some methodological consensus in the face of substantive disagreements among them.” 176 Reviewing the cases in which plain meaning was invoked, he concludes they share two characteristics. First, the cases are substantively uninteresting. 177 Second, they involve areas in which members of the Court have little “context-sensitive expertise.” 178 Professor Schauer explains that plain meaning is a means to achieve consensus decisions in cases which are, for the Court, both time consuming in their complexity and yet uninteresting in their substance. 179 Securities cases are complex and largely outside the expertise of the Court. They also may be uninteresting to the Justices.

This latter point may be the key to understanding the seemingly anomalous use of literalism in the Landreth decision. By taking a literal approach to “stock,” and thereby rejecting the “sale of business” doctrine, the Court opened the federal courts to claims which offer little justification for consuming the resources of the federal court system. 180 Previous uses of plain meaning in securities cases could be seen as motivated by a larger agenda to restrict access to federal courts by private litigants asserting federal securities violations. 181 In fact, the “sale of business” doctrine’s purpose-based analysis was also seen as motivated by this larger agenda. 182 Therefore, it was surprising to see the Court adopt a literalist approach to stock since it expanded, rather than contracted, the scope of the federal remedy. But if the plain meaning approach is invoked not as a means to a substantive outcome, but rather as

174. See Galie, State Supreme Courts, supra note 166, at 110 (stating that “[t]he case for a more active judicial role is stronger at the state level”); Galie, The Other Supreme Courts, supra note 166, at 792 (same).
175. See Schauer, supra note 163.
176. Id. at 232.
177. Id. at 253. That is, uninteresting to constitutional law scholars and, therefore, presumably Supreme Court Justices.
178. Id. See also Note, supra note 159, at 900-01 (identifying “heightened sense of judicial incapacity” as motivation for plain meaning approach).
179. See Schauer, supra note 163, at 254.
180. See discussion supra Part II. B.
181. E.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (finding that scienter requirement for actions under Rule 10b-5 is derived from plain meaning of term “manipulative”). See also Note, supra note 159, at 910-12 (identifying literalism as part of substantive agenda to limit regulation and restrict access to federal courts).
182. See Karjala, supra note 46, at 419; Prentice & Roszkowski, supra note 19, at 506-09; Thompson, supra note 44, at 225-27.
an institutional solution for expediting the resolution of complex, yet deemed unimportant cases, the anomaly evaporates. What is left, however, is the
void created by the federal courts' abdication from a deliberative development of securities regulation. If the federal courts look only for the easy ways to
dispose of securities cases, it will be left to the state courts to provide thoughtfu!
wherever practicable." The one instance in which the state statutes specifically anticipate coordination is in the registration process. To avoid the unnecessary cost of multiple registration filings, the statute allows issuers who have filed with the federal authorities to register with the state administrator by simply providing copies of the federal filings. Duplicative filing requirements are clearly wasteful. It is therefore not surprising that the state statute emphasizes uniformity in "registration statements, applications, and reports." But does a policy of coordination extend beyond efforts to reduce the paperwork requirements of a system of dual regulation? Is the same clear benefit obtained by making application of the statute uniform between the federal and state, or even among various state, regimes? The logic of avoiding wasteful duplication through coordination does not ineluctably extend to the question of diversity in the scope of each state's statute. To see this point, consider a recent state court decision.

In *New Mexico Life Insurance Guaranty Ass'n v. Quinn & Co.*, the issue that the court addressed was whether certain annuity contracts would be exempt from registration under the state securities act. In deciding that they were exempt, the court adopted as applicable under the state act a Securities and Exchange Commission rule that provided a safe harbor exemption for annuity contracts under federal law. In explaining its decision to incorporate the federal administrative rule into its state regime, the court stated:

To better serve the smooth flow of interstate commerce in these products, and to foster a healthy business climate in this state, we now adopt federal precedent in construing the New Mexico definition of "security" in cases implicating annuity products. Otherwise potential New Mexico offerors of the products would face the uncertainty of what may be different legal requirements in this state.

This notion that "a healthy business climate" requires uniformity among states and between states and the federal government in defining the proper subject matter of regulation underlies the extension of the coordination logic to the definition of security. This logic is compelling only if one opposes regulation generally, and not simply the waste of duplicative filing requirements.

Diversity in the definition of "security," and thereby in the scope of securities regulations, can generate two possibilities—states with lesser regulation or states with greater, in each case the benchmark being the level of

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federal regulation. In the former case, lesser regulation, the diversity will have no impact on interstate commerce since federal regulation will impose the minimum standard. It is only in the later case, greater regulation, that diversity will matter. New Mexico might, for example, extend its registration and antifraud requirements to the sale of annuity contracts when no other authority, federal or state, does. But why is this difference necessarily antithetical to a "healthy business climate?" To reach that conclusion, one must have also concluded that the regulation under the securities act of the sale of annuity contracts is unhealthy.

The authors make no pretense to resolving, or even contributing to the debate that one set of commentators described as the "intellectual stalemate between those who favor strong state regulation of business and those who advocate deregulation." Our point is that if one is equivocal as to the wisdom of a broad regulation of the sale of investment devices, there is no coherent objection to diversity in the definition of "security." Since regulation may, in fact, be healthy, such as by providing market confidence, New Mexico should feel free to experiment with regulating the sale of annuity contracts. By differing from other states, New Mexico may in fact offer an even more hospitable business climate for offerors of annuity contracts. By differing from the federal choice, it will surely contribute to a multiplicity of experiences that will serve the incremental development of securities regulation.

This last point deserves some elaboration. Not only is diversity in the scope of state securities acts permissible since there are no unequivocal benefits to uniformity, but diversity offers an affirmative value of its own as well. Unlike the almost unquestioned ethic of uniformity in state and federal securities regulation, numerous writers have articulated the benefits of diversity within a system of dual regulation when discussing constitutional issues and individual rights. Consider, for example, the following statement by Shirley Abrahamson, a member of the Wisconsin Supreme Court:

194. An example of the benefits of multiple experiences might be seen in Cellular Eng'g, Ltd. v. O'Neill, 820 P.2d 941 (Wash. 1991). In that case the court looked to both similar federal experience and analogous sister state experience to determine whether FCC cellular phone license lottery pools should be subject to the state securities act. Id. at 950-51.
195. See, e.g., Shirley S. Abrahamson, Reincarnation of State Courts, 36 Sw. L.J. 951, 972-74 (1982) (5th Annual Roy R. Ray Lecture) (providing extensive bibliography of literature); Erwin Chemerinsky, Parity Reconsidered: Defining a Role for the Federal Judiciary, 36 UCLA L. Rev. 233, 302-10 (1988) (arguing that litigants should have available both federal and state forums for vindicating personal liberties); Galie, The Other Supreme Courts, supra note 166, at 791 (arguing that state courts can serve as laboratories in federal system). But see Earl M. Maltz, The Dark Side of State Court Activism, 63 Tex. L. Rev. 995 (1985) (arguing against state court activism).
How am I as a state judge to decide what the state constitution means? I use the same techniques as I use to decide what any law means. I try to find the intent of the framers . . . . I examine the earlier decisions of our court, the decisions of sister courts, and the decisions of the United States Supreme Court construing the same or similar provisions. The reasoning of other courts may be persuasive. I look at the peculiarities of my state—its land, its industry, its people, its history. Alas, it would be easier for me just to read the writings of the United States Supreme Court . . . and follow the teachings. Why take the hard road when you can take the easy path?

I advocate the process of analyzing the state constitution because I think such analysis has positive advantages. One advantage of such analysis is diversity . . . .

. . . .

New federalism serves as a reminder to state courts that they should experiment with new approaches that, if successful, may later be applied nationwide by the United States Supreme Court. State experimentation serves to guide the Supreme Court in its determinations. 196

The same words could be spoken in favor of experimentation with the scope of securities regulation. 197 Simply replace in the foregoing passage the phrase “state constitution” with “state securities act.”

V. Turning “Investment Contract” Inside Out: General Partnerships and Other Rattlings Inside the Howey Cage

A. Labels as Literalism

Neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 contains the word “partnership” in the statutory laundry list of items denominated a security. 198 A consequence of that omission is that, in order to hold that a partnership interest is a security, that interest must come within

196. Abrahamson, supra note 195, at 965-66. See also Galle, The Other Supreme Courts, supra note 166, at 791 (noting that state courts are freer to experiment since their decisions have only local impact).

Or, to quote Justice Brandeis, “It is one of the happy incidents of the federal system that a single courageous state [court] may . . . serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.” New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

197. As a matter of fact, these words have been spoken. See LOUIS L O S S & EDWARD M. COWETT, BLUE SKY LAW 237 (1958) (stating that “if individual states want to go further than disclosure [i.e., the emphasis of federal securities regulation], it is part of the genius of our federal scheme that they should be permitted to do so”) (footnote omitted).

the catchall "investment contract," as developed in SEC v. W.J. Howey Co.\textsuperscript{199} and subsequent cases.

The federal courts' application of investment contract analysis to general partnerships provides another example of the literalist approach that has swept federal courts in the 1980s and 1990s. However, this time courts are not reading the text of a statute literally, but instead, they are reading the label of a document literally.

Eschewing mandates that prevailed from the 1930s to the 1970s that courts should construe securities legislation with its remedial purposes in mind,\textsuperscript{200} and that courts should look beyond labels to the economic realities of transactions,\textsuperscript{201} federal courts have begun to search no further than the label on the face of a document. If that label is general partnership, and the paperwork bears that out, courts have looked no further. When defendants moved to dismiss, appending copies of partnership agreements to their motions, federal courts ignored whatever economic realities might be present. Almost as a matter of docket control, courts seized the opportunity presented to eliminate entire portions of their caseload. Literalism, as applied to securities cases involving general partnerships, became neither a means of doing justice nor an instrument of federalism or other constitutional concerns. It became simply a plebeian tool to reduce the courts' workload.

B. The Polar Star—Williamson v. Tucker and Other "Early" Cases

Earlier cases dealt with partnership interests as securities.\textsuperscript{202} The modern era begins, however, with the Fifth Circuit's opinion in Williamson v. Tucker.\textsuperscript{203} In Williamson plaintiffs purchased undivided interests in a 160 acre parcel near the site of the future Dallas-Fort Worth Airport. They reconveyed those interests to joint ventures structured as general partnerships by a local investment company. When the "sure thing" did not unfold as planned, plaintiffs defaulted on the promissory notes they had executed. Their sellers, original owners of the parcel, foreclosed. In turn, the four plaintiff general partners sued both the investment company who promoted the joint venture and their sellers under the securities acts. The first half of the lawsuit depended upon whether the general partnership interests were investment contracts.\textsuperscript{204}

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\textsuperscript{199}. 328 U.S. 293, 298-99 (1946) (holding that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party").


\textsuperscript{201}. See United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848 (1975) (stating that "[I]n searching for the meaning and scope of the word "security" ... form should be disregarded for substance and the emphasis should be on the economic reality") (quoting Tcherepnin).


\textsuperscript{203}. 645 F.2d 404 (5th Cir. 1981).

\textsuperscript{204}. The second half of the lawsuit depended upon whether the promissory notes they had delivered to the sellers were securities. See Williamson v. Tucker, 645 F.2d 404, 426-29 (5th Cir. 1981).
The district court had ruled they were not, dismissing the suit for lack of subject matter jurisdiction.205

"On the face of a partnership agreement," the court found, "the investor retains substantial control over his investment and an ability to protect himself..."206 The court followed with the most oft-quoted language in the partnership field:

Such an investor must demonstrate that, in spite of the partnership form which the investment took, he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful partnership powers. A general partnership or joint venture can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager... or otherwise exercise meaningful partnership or venture powers.207

The enumerated items have become known as the "three prongs" of Williamson v. Tucker. In shorthand, they are (1) text of the partnership agreement; (2) character or nature of the investor; and (3) character or nature of the manager or promoter.

In Williamson, the court remanded for application of its three pronged test but plaintiffs' future was not bright: (1) the partnership agreement did nothing to negate the traditional powers of control that general partners have; (2) the plaintiffs were all past and present executives of the Frito-Lay Company and were thus experienced in business affairs; and (3) the investment company was to act as a real estate developer, hardly a role requiring unique or irreplaceable expertise.

C. Down the Channel Toward Literalism—Truncation of the Three Prong Test to the First Prong

Williamson is a solid nautical chart for an economic realities inquiry when a lawsuit presents a general partnership interest issue. Although the Williamson test includes three prongs, other federal courts quickly began focusing exclusively on the first prong. A notable example was Goodwin v. Elkins & Co.208 Goodwin was a longstanding general partner of a regional brokerage firm. He was persuaded to advance his retirement date by a few
months. He sold his partnership interest back to the partnership. He later found out that his partners had rushed him in order to sell the entire firm to Bache, Halsey, Stewart a few months later for a handsome profit that now had to be sliced into one fewer share. Goodwin's case was precisely of the sort that many seminal securities law decisions have involved.  

Goodwin protested that he had little power or responsibility: "his actual position was no more than that of a limited partner . . . effective control of the firm rested exclusively with the Managing Partner and the Management Committee of the firm." Although Goodwin's characterization of the actual situation may well have been accurate, the Third Circuit swept it aside. Judge Garth applied only the first prong of Williamson v. Tucker. Under the Pennsylvania partnership statute and the Elkins & Co. agreement, in theory Goodwin had the power to exert control over partnership affairs or to obtain information. As the court put it, "[w]hether a partnership interest constitutes a security depends upon the legal rights and powers enjoyed by the partners." Never mind that collective action problems might prevent Goodwin or the other partners from coming together to wrest control from the managing partner or that Goodwin's lame duck status may have prevented any searching inquiry by him into partnership affairs. Instead Judge Garth and Chief Judge Seitz (in a concurring opinion) converted a sideshow into the main event. They debated merely whether they should look at the agreement alone or at both the agreement and the partnership statute to determine what the general partner's "legal rights" were.

The nautical metaphor becomes appropriate again with Rivana Trawlers Unlimited v. Thompson Trawlers. Retired Supreme Court Justice Powell, sitting by designation, purported to apply Williamson v. Tucker. In reality, he either narrowly applied the case or applied a slightly expanded version of the Goodwin v. Elkins & Co. "first prong only" analysis. As to the former, he characterized Williamson v. Tucker as a "narrow exception to the strong presumption that a general partnership is not a security" and noted that "only under certain limited circumstances can an investor's general partnership interest be characterized as a security." As to the latter, he recited salient

209. Indeed, the very first action giving money damages for a Rule 10b-5 violation was such a case. See Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).
211. Id. at 107 (emphasis in original).
212. 840 F.2d 236 (4th Cir. 1988).
214. Id. at 241. He continued, stating that "the presumption that the general partnership is not a security can only be rebutted by evidence that it is not possible for the partners to exercise those powers [given them by their agreement and the partnership statute]." Id. In a footnote, he added

If and to the extent Williamson and other cases may be read to require a court to look to the actual knowledge and business expertise of each partner in order to assess his or her ability intelligently to exercise the power of a general partner, we do not agree. Such an inquiry would undercut the strong presumption that an interest in a general partnership is not a security.

Id. at 241 n.7.
features of the partnership agreement, finding "the ability to control the profitability of the enterprise." 

Plaintiff investors in Rivana were twenty-four passive investors who purchased interests in partnerships formed to acquire and operate four fishing vessels. They badly undercut their argument for application of Williamson's second or third prongs by having twice removed Rivana Trawlers' external managers and also by having replaced the original managing partner. But again, though, Mr. Justice Powell's sole emphasis was upon the terms of the partnership and Williamson v. Tucker's first prong.

D. A Near Free Fall into the Abyss of Literalism—The Ninth Circuit and General Partnership Interests as Investment Contracts

For an extreme position in the general partnership as investment contract area, one need only look to the Ninth Circuit. In Matek v. Murat, twelve San Pedro, California investors put $100,000 each into a partnership formed to convert a surplus navy vessel into a fish processor. When the deal soured, they sued the promoter and his law firm. The defense claimed that general partnership interests are not securities.

Judge Wiggins writing for the majority purportedly rejected the "bright line" legal rights only approach of Goodwin, opting instead for Williamson and its economic realities inquiry. However, he then rejected the second and third prongs of Williamson v. Tucker reasoning that:

The two other "prongs" ... create uncertainty in the area of business investing. They require that a promoter investigate the business experience and acumen of all potential investors and then tailor his offerings to them. To some he might offer a general partnership interest, to others a security.... The focus must be on the expectations the parties had in the original transaction. ... The Williamson test would also require the courts to find an investment a security in relation to some investors and a partnership in relation to others.... Categorizing the plaintiffs in that fashion is untenable.

Judge Wiggins never reveals why requiring a promoter to investigate the business experience and acumen of potential participants in an offering is a bad thing. As a matter of preventive law, such action is recommended practice for those conducting small and exempt offerings such as the one involved in Matek. Screening and even pre-screening of potential offerees by use of

215. Id. at 242.
216. 862 F.2d 720 (9th Cir. 1988).
217. See Matek v. Murat, 862 F.2d 720, 727 (9th Cir. 1988).
218. Id. at 730 (noting that "[w]e decline, however, to adopt the other two 'prongs' of the Williamson test") (footnote omitted).
219. Id. at 729.
questionnaires and similar devices is a practice many in the industry follow.

Applying the first prong of Williamson, Judge Wiggins noted that "[t]he terms of the agreement provide them with all the access and ability to protect their investment that the securities laws would otherwise provide." This was a "standard general partnership" and therefore not a security. Judge Wiggins did put a gloss on the first prong of Williamson. He "found no evidence that the general partnership agreement was purposefully drafted to escape the application of the securities laws," intimating that if the partnership form were abused in that way he would find an investment contract.

Following Matek several Circuit Court opinions rejected meritorious claims because the promoters had structured their deals as "general partnerships" or because the transaction involved a general partnership interest. Labels and literalism prevailed. Ninth Circuit district judges only had to look at the appellation the promoter and his lawyer had appended to the item. A quick confirming glance at the partnership agreement ended the case, at least as a federal securities matter.

E. Nautical Chart for Evasion—The Economic Realities of Investments Structured as Partnerships

Beginning with Williamson and Goodwin and accelerated by cases such as Matek, a trend emerged. Every promoter who knew what she was doing, or who had a decently schooled transactional lawyer, structured their deal as a general partnership. Breeding bull deals, vineyard partnerships, real estate syndications, Christmas tree and ornamental shrub growing ventures, wheat farm transactions, and all other manner of deals, unlike the traditional partnership because they involved the coming together of perfect strangers, hit the streets as general partnerships. Because the general partners remained liable for the partnership debts, the risks were very high. The tales of woe told by quite ordinary middle class investors proliferated. They were the victims of literalism, although telling them would be of little solace. What also became apparent is that the federal judges applying this literal approach did not have the slightest clue of what the economic realities were.

A typical transaction would work in a similar manner as the following example. After several good years in his apple orchard, Farmer Greenjeans could foresee a market glut caused by high prices and resulting increased production. Longer term his choices might be bankruptcy on the downside,

220. Id. at 731.
221. See, e.g., Banghart v. Hollywood Gen. Partnership, 902 F.2d 805, 808 (10th Cir. 1990) (holding that movie production partnership involving passive investors is not security) (citing Matek); Reeves v. Teuscher, 881 F.2d 1495, 1499-1500 (9th Cir. 1989) (holding that general partnerships interests in limited partnerships formed to sell and develop desert real estate are not investment contracts).
or syndication on the upside. Along come promoters Bert and Ernie, trained as accountants or engineers or real estate developers. Bert and Ernie offer a very high price with very little down to Farmer Greenjeans for his Chief Joseph orchard, but Farmer Greenjeans will have to wait up to six months for closing. Farmer Greenjeans takes the high road—syndication is for him.

Bert and Ernie return to the city. They roll up their sleeves. First they subdivide the orchard. They break up the sixty acre orchard they are to acquire for $900,000 into ten six acre plots, each plot to be owned by a separate general partnership (Chief Joseph Partnership Number One, Chief Joseph Number Two, Chief Joseph Three . . .). Bert and Ernie file a plat of subdivision with the local authorities.

Next they draft an offering circular. With attachments (partnership agreement, master partnership agreement among partnerships, horticultural agreement, and more) the offering document will rival the Minneapolis telephone directory in size. The offering will seek to raise not $900,000, not $1.1 million but, over time, $1.5 million. Each partnership will raise one tenth of that, or $150,000. Investors do not even have to come up with their share of that sum. To be one of five partners in the partnership, each investor puts forward $15,000 cash and a $15,000 promissory note, backed by a letter of credit from a commercial bank.

Upon analysis, the deal looks very conservative. Bert and Ernie will raise $750,000 cash, they only owe Farmer Greenjeans $900,000, and they will have apples to sell in several months’ time. The deal is not quite conservative as would appear, though. Bert and Ernie receive $250,000 off the top as a “syndication fee.” They take $100,000 or so as a first year “management fee.” They reimburse themselves $80,000 for the costs of the offering (accountants, lawyers, printing). The management account gets $70,000 for chemicals, tractor fuel, improvements to the irrigation system, and the like. An additional $70,000 is kept in reserve to make the monthly payments to Farmer Greenjeans. Those payments have to be made until such time as sale of the apple crop kicks in, after which (off the record, of course) the investors are told they probably will never have to pay another cent.

The promissory notes are a precaution only. Easy street is just around the corner. Projections in the offering circular confirm this. Those projections show that under Bert and Ernie’s expert management and horticultural methods production will increase every year. Not only that, apple prices will also increase every year. In year two, proceeds from the apple crop will cover all, or nearly all, payments to Farmer Greenjeans. By year three of the partnership, there will be a positive cash flow, much of which will be


The land sales contract . . . provides for a uniform purchase price per acre . . . . Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees . . . . These tracts are not separately fenced . . . .

The purchasers for the most part are non-residents of Florida. They are predominantly business and professional people who lack the knowledge, skill and equipment necessary for the care and cultivation of citrus trees.
distributed to the partners. By year four and year five, that flow will become a torrent. Hooray for Bert and Ernie. They sure are smart and know how to structure a deal. And with their management skills, they certainly deserve that syndication fee. Everyone will be rich.

But, in reality, Bert and Ernie do not know how to manage apple orchards (or Christmas tree farms, or breeding operations, or whatever). They are real estate developers who live in nice yuppie suburbs. Even if they did know their pomology, Bert and Ernie are too busy. They are seeking out other orchards to syndicate. They want to operate this money machine they have invented two or three times a year. After five years, with ten to twelve orchards syndicated, Bert and Ernie will be splitting $1 million to $1.2 million in annual management fees.

So Bert and Ernie must hire a manager to oversee their orchards. Of course, Bert and Ernie are strangers to the district. The chances are that the manager they are able to hire (a) is inexperienced, (b) has a substance abuse problem, or (c) is lazy. Besides, their manager must oversee five, six or seven orchards. So the manager subcontracts with Mr. Greenjeans actually to manage Chief Joseph. Mr. Greenjeans, however, wants to swing in his hammock, drinking ice tea, so he hires young kids or itinerant workers who do the hands on spraying, pruning and other tasks an apple orchard requires.

The net result is that Bert and Ernie have taken a cyclical business, marginal even in fairly good years with one set of managers, and overlaid a four-tiered management structure with each tier taking its own bite out of any proceeds of the crop. Then, too, apple prices fall instead of rising. With these marginal managers in place, production falls, too. There is a double-barreled effect with falling prices and falling output. The projections in the offering circular are working—but in reverse.

In year two the investors must pay on their notes. Their cash outlay has doubled. In year three, year four and year five the investors have to dig into their pocketbooks to carry the mortgage to Farmer Greenjeans, the management fee to Bert and Ernie, and possibly other expenses as well.

The investors meet and they grumble, but they have no choice. They are general partners and liable on a plenary basis. Besides, Bert and Ernie's lawyer telephones them, haranguing much in the manner of Kilgore Trout. The investors look at the partnership agreements. Sixty percent of the partners in each partnership and sixty percent of the partnerships must take action to remove Bert and Ernie as managers. It would take a lot of groundwork to get everyone pulling together like that, especially since the investors are spread among several cities and states.

224. And it is a money machine. If Bert and Ernie do it right, they need only a few thousand in cash. They need a thousand or two as earnest money to accompany the offer of purchase to Mr. Greenjeans and a similar amount as a retainer to a lawyer. Otherwise, through stretching out the closing date with Mr. Greenjeans or by using a double escrow they are never out significant amounts of funds. Who says you can't make something from nothing?

225. See generally Kurt Vonnegut, Jr., GOD BLESS YOU MR. ROSEWATER (1967).
The investors, for the most part of modest means and background, include a railroad engineer, a high school teacher, a truck driver, an FBI agent, a power company engineer, and so on. They all live several hundred miles from the orchard. They are mystified by what has happened. Because the investment is structured as a general partnership, each is on the hook now for $75,000 or $85,000 per unit. Some even purchased two units. Their finances are strained to the breaking point. About $1,500 of every monthly paycheck goes to carry the orchard investment. Finally, they say "no more—no more good money after bad." They organize, they finally have partnership meetings, and they hire a lawyer.

The lawyer sues Bert and Ernie, the accountants who did the "compilation," the bank who kept the enterprise afloat by providing funds based on assignment of proceeds of partnership assessments, the lawyer who copied each offering circular from the previous one, changing only some of the names and numbers, and the securities salesman who sold the deal to plaintiffs. The action is either a class action or a direct action with several dozen named plaintiffs. Either way it is a sizeable lawsuit.

Arriving in federal court, the parties skirmish for a time. The plaintiffs then encounter a defense motion to dismiss for lack of subject matter jurisdiction or for failure to state a claim upon which relief can be granted. The grounds are that general partnership interests are not securities. The judge reads the defense brief, leafs through the partnership agreement to see if anything unusual is contained therein, perhaps in passing notes the uncanny resemblance to the facts of SEC v. W.J. Howey Co., and dismisses the lawsuit, seeing a neat and clean way to clear the docket. Plaintiffs refile in state court on common law fraud and breach of fiduciary duty grounds where, if the state statute of limitations has not run, they may obtain relief eventually.

These general partnership cases were paradigm investment contract cases. They were beyond paradigm because the general partnership feature and accompanying unlimited liability made the risk threefold or more that involved in a limited partnership or incorporated venture, which would always be found to involve a security.

That then was the tale of woe born of literalism in the general partnership field. Time and time again scenarios similar to the one just described played themselves out in the trial courts. And who were the winners? Federal judges, who cleared their docket a bit. And Farmer Greenjeans who, after becoming

226. Many promoters organize and script partnership meetings along the way, usually upon advice of counsel. If sued under the securities laws, the promoter can say not only did the partners have legal rights, they exercised some of them.
230. A similar observation can be made about the "sale of business" doctrine. See the discussion of Barnes v. Sunderman, supra notes 66-71 and accompanying text.
$400,000 or $500,000 richer, foreclosed on the property, moved back into the farm house (if he ever left), and will live to syndicate again, probably as a general partnership.

F. A Return from the Abyss to the Land of Economic Reality

The Ninth Circuit eventually recognized the incongruity of what they had done and pulled back from the literalism they had earlier espoused. The pullback began with a condominium in Hawaii. Plaintiff Hocking visited Honolulu from his home in Las Vegas. Real estate agent DuBois sparked his interest in a $115,000 condominium by telling him that the unit would reap $100 per day in rentals and that a rental management agreement and rental pool agreement with management company HCP would join Hocking with many other owners in a complex that would be managed as a first rate resort hotel. Little of this came to pass. Hocking defaulted on his note, lost the condominium and his $24,000 down payment. Hocking sued, styling his complaint *Hocking v. DuBois*. 231

To determine whether the package of condominium and rental pool agreement constituted an investment contract, that is, whether they raised the expectation of profits from the efforts of others, Judge Goodwin, on behalf of an en banc court, applied the teachings of a general partnership case, namely, *Williamson v. Tucker*. As to the first prong of *Williamson*, he found that Hocking had the legal power to manage the asset. The rental pool arrangement was terminable during an annual ninety day period and the management agreement terminable on thirty days notice. 232

Hocking, however, successfully argued application of both second and third prongs. He claimed to be "an unsophisticated, inexperienced investor [who] resides thousands of miles away." He thus might not have had the ability to exercise whatever legal rights he had under his agreements. As to the third prong, the court found that the manager might indeed be irreplaceable. That the complex was managed as a hotel and that a seventy percent vote of unit owners was required to change managers created "a real question whether Hocking was stuck with HCP as a rental manager." Management who could and would operate the place as a hotel "may be a much more difficult service to replace than that of a long term leasing agent." 233 The court remanded for factual inquiries on the second and third prongs of *Williamson*.

*Hocking v. DuBois* involved a condominium, not a partnership. In the very next partnership case, however, the Ninth Circuit held that "reliance on *Matek* [was] misplaced ... in light of the subsequent en banc opinion in *Hocking v. DuBois*." 234 Investors in a 2700 acre jojoba bean plantation

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231. 885 F.2d 1449 (9th Cir. 1989) (en banc).
233. Id. at 1461.
234. Koch v. Hankins, 928 F.2d 1471, 1477 (9th Cir. 1991). In so doing, the court struck a blow against literalism. See id. at 1478. The court stated:
numbered 160 and purchased interests in 35 partnerships numbered I through XXXV. They persuaded the Ninth Circuit panel that they came within the second and third prongs of *Williamson*. Since jojoba farm managers were not readily available, and replacement of management required an investor "to catalyze a vote in each of the thirty five partnerships," in addition to her own, "even if a general partner vigorously exercised ... her rights under the partnership agreement, ... she arguably could have no impact on the investment ..." The partnership inquiry was re-focused on economic realities. The upsurge of literalism in the Ninth Circuit had been quashed.

In a subsequent opinion, another panel confirmed that the en banc opinion in *Hocking* "replaces *Matek* as controlling in the Circuit." It remains to be seen if other Circuits will follow, or if the Supreme Court will let them.

**G. Literalism in the State Courts—Reluctance Again to Follow the Feds**

From time to time, a state court slipped into the literalist mode. For example, in *Bahre v. Pearl*, the Supreme Court of Maine noted that "federal case law provides some guidance to state courts ... but is not controlling ..." The court then went on to do the opposite. By rote, the court applied the literalist approach of federal courts to find interests in a general partnership formed to redevelop property on the Portland waterfront not to be investment contracts, citing *Banghart v. Hollywood General Partnership* and *Rivana Trawlers*.

More analytical and more in keeping with state courts' role as courts of general jurisdiction is a Missouri Appellate Court opinion, *State v. Kramer*, finding a general partnership interest to have been a security. The court first eschewed a literalist approach:

> [I]n determining the applicability of the Securities Act, we look beyond labels and language and form to the economic realities involved in the transaction. ... The courts in Missouri have long recognized the need to look to substance rather than form and to examine all the circumstances...

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*The promoters also seek to distinguish *Hocking* on the basis that it did not address a general partnership but involved a condominium and rental pooling agreement. This second point is a distinction without a difference, running directly counter to *Howey's* mandate that courts address "economic reality" rather than focusing on the labels attached to schemes by promoters.

Id. at 1480-81.

235. Id. at 1480-81.

236. Holden v. Hagopian, 978 F.2d 1115, 1119 (9th Cir. 1992) (holding horse breeding partnership not to be security because investors were experienced and sophisticated and because plaintiffs failed to demonstrate that there was no "reasonable replacement" for manager).

237. 595 A.2d 1027, 1031 (Me. 1991).


239. 902 F.2d 805, 808 (10th Cir. 1990).

240. 804 S.W.2d 845 (Mo. App. 1991).
surrounding the transaction in order to effectuate the purpose of securities laws.\textsuperscript{241}

The policy reason for rejecting the literal approach was that

This flexible approach, looking to substance rather than form, to economic reality rather than terminology, is predicated upon a recognition of the fact that the ingenuity of those who resort to "get rich quick schemes" to fleece the gullible public is boundless. No hard and fast rule or rigid definition of "security" or "investment contract" which is impervious to evasion can be devised.\textsuperscript{242}

A similar opinion from the heartland is a Kansas Appellate Court decision, \textit{State v. Ribadeneira},\textsuperscript{243} involving sale of a general partnership interest in a real estate limited partnership:

[T]he sale of a general partnership interest is \textit{generally} not considered the sale of a security. . . . However, our Supreme Court has made it very clear that the fact of labeling something as a general partnership does not make it so. As Justice Prager said . . . "This test is to be applied in light of the economic realities of the particular contractual arrangement . . ." An interest labeled a general partnership can, in fact, be a security despite its denomination.\textsuperscript{244}

The court cited none of the newer federal partnership cases. Instead, it relied on \textit{Howey} and \textit{SEC v. Glenn W. Turner Enterprises} in upholding the trial court finding of security.

Similar to the Missouri approach in \textit{Kramer} or the Kansas approach in \textit{Ribadeneira} is an Arkansas general partnership case, \textit{Casali v. Shultz}.\textsuperscript{245} Defendant Shultz was a senior vice president of an Arkansas based financial services company who wanted his own firm. Using a general partnership, he raised $1.2 million from eight Little Rock physicians, an art dealer, and the plaintiff to purchase an obscure New York investment banking firm. The Arkansas Supreme Court found a security under all three prongs of \textit{Williamson v. Tucker}, adding thereto its own analysis:

[R]egardless of the label on a document, the underlying economic substance of a security is an arrangement where the investor is a mere passive contributor of risk capital to a venture in which he has no direct or managerial control.

The mere fact that an investment takes the form of a general partnership does not insulate it from the reach of the Arkansas Securities Act.\textsuperscript{246}

\textsuperscript{241} State v. Kramer, 804 S.W.2d 845, 847 (Mo. App. 1991).
\textsuperscript{242} Id. at 848.
\textsuperscript{245} 732 S.W.2d 836 (Ark. 1987).
\textsuperscript{246} Casali v. Shultz, 732 S.W.2d 836, 837 (Ark. 1987) (citation omitted).
Other cases form part of this mosaic of mutiny in the state courts in the
general partnership area. Pointedly, other state appellate courts have ignored
the literalist federal court decisions of the modern era.\textsuperscript{247} In truth, the picture
is not uniform.\textsuperscript{248} Of eight recent state appellate decisions we found in the
partnership investment contract area, five found a security to be present or
leaned strongly in that direction.\textsuperscript{249} In several of those cases, state appellate
court judges obviously felt that they, as well as state securities law, had a
different role to play than the federal courts, one of gap filling and investor
protection.

VI. Conclusion

This Article began by identifying the United States Supreme Court’s most
recent utterances on the definition of security as rejections of a previous,
longstanding economic realities approach. In \textit{Landreth} and \textit{Gould} and, to a
lesser extent, in \textit{Reves}, the Supreme Court has instructed the federal courts
to approach the securities statutes literally and to shun a purpose-based
inquiry to determine whether the case at hand merits application of the federal
securities laws’ protections. The authors bemoan this development for several
reasons.

First, we join the chorus which has found the Supreme Court’s recent
descent into a textualist or literalist interpretational methodology as dishon-
est.\textsuperscript{250} Interpretation inescapably calls for extra-textual considerations, and
literalism often leads to absurd results. As observers of the rapidly evolving
securities industry to which the statutes written some six decades ago must
be applied, we think it more meaningful to assume that “[s]tatutes . . .
should—like the Constitution and the common law—be interpreted ‘dynam-
ically,’ that is, in light of their present societal, political, and legal context.”\textsuperscript{251}

noted that the investors were unsophisticated persons lured into the scheme by a defendant to
whom they had come for estate planning. The court added lack of sophistication as a distinct
element of a \textit{Williamson v. Tucker} approach, noting that:

This analysis squares with the purpose of the State Securities Act which is to protect
people from schemes, such as the one considered here, which defraud the public. . . .
[Allowing the facial terms of the investment to dictate whether the statute applies]
would insulate clever schemers from criminal responsibility and fail to provide protec-
tion to victims.

\textit{Id.} at 288 (Lane, J., concurring). \textit{See also} \textit{Garrett v. Snedigar}, 359 S.E.2d 283 (S.C. App. 1987)
(reversing summary judgment in plaintiff’s favor as premature but quoting liberally from \textit{Howey}
and \textit{Tcherepnin v. Knight}).

\textsuperscript{248} See, e.g., \textit{Brannon v. Rinzler}, 603 N.E.2d 1049 (Ohio App. 1991) (holding that tax
shelter general partnership is not security); Shinn v. Thrust IV, Inc., 786 P.2d 285 (Wash. App.
1990) (holding that odd individually negotiated limited partnership with land owner as limited
partner and house builder as general partner is not security).

\textsuperscript{249} Alphabetically, those cases are \textit{Casali} (Arkansas), \textit{Garrett} (South Carolina), \textit{Kramer}
(Missouri), \textit{Probst} (Oklahoma), and \textit{Ribadeneira} (Kansas).

\textsuperscript{250} See, e.g., Farber, \textit{supra} note 159, at 289-90; Sunstein, \textit{supra} note 159, at 416-24.

\textsuperscript{251} William N. Eskridge, Jr., \textit{Dynamic Statutory Interpretation}, 135 U. PA. L. REV. 1479,
We do not see how it could be otherwise and still have the federal securities laws serve a socially beneficial function.

Second, we believe the Supreme Court missed an important opportunity to develop a holistic approach to the definition of "security," and thereby the scope of the federal securities laws, when it restricted the Howey test to investment contracts. The Court stated that to apply "the Howey test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous." But this sort of grammarian logic is too simple. Consider again the text of the definition of "security" in the Securities Act. It does in fact provide a list of instruments such as stock, notes and investment contracts. But the list ends with the following phrase: "or, in general, any interest or instrument commonly known as a 'security'..." As one commentator has put it, the definition's litany of examples serve both a "connotative" and a "denotative" purpose. Therefore, while the individual instruments listed are separately included as securities, they also collectively serve as examples of the general concept of a security. Consider another example. One approach to the definition of "animal" is to provide an abstracted distillation of the essential qualities of an animal. Thus we might say, "any of a kingdom (Animalia) of living beings typically differing from plants in capacity for spontaneous movement and rapid motor response to stimulation." The other approach, used in the definition of "security," is to define by example. Therefore we might define "animal" as "including any mammal, reptile, bird, fish, or, in general, other creature commonly known as an animal." The list of examples is neither exhaustive nor itself devoid of definitional difficulty. But it conveys the abstracted concept since each example manifests certain characteristics common to all. On the other hand, each separate example also has characteristics unique to itself, such as gills or wings or methods of reproduction.

The question for the Howey test was whether it served only to identify characteristics unique to investment contracts or whether it sought to divine the part by reference to the whole. The Court could have easily read its investment contract precedents and their focus on economic realities as striving for a connotative understanding, an abstract distillation of the entire litany of examples rather than as an inquiry into the limited realm of investment.
contracts.\(^{258}\) Instead the Court read the *Howey* test as looking for gills or wings. It is telling that in its very next opinion, the Court had to struggle with its refusal to pursue a connotative definition of "security." While the Court attempts to limit its new four-prong test established in *Reves* to determining only the exceptions to the general presumption that notes are securities, as we have seen in the state courts, that analysis has subsumed the presumption.\(^{259}\) Whether they like it or not, the Justices will always be forced to apply some multi-factor test to the outer margins of "security." In *Landreth*, they seemed to throw away several generations of work on developing one.

Finally, as has been the main contention of this Article, the authors bemoan the literalist approach because of its influence on the state courts' approach to their own securities laws. While generally the economic realities test is alive and well in the state courts,\(^ {260}\) the literalist approach has made some inroads under the aegis of federal-state harmony, notably in the cases involving stock.\(^ {261}\) The authors contend that the state courts should pursue the development of their economic realities approach even if that requires open rejection of federal decisions.

As we have already stated, we believe the economic realities approach provides the better avenue for developing a cogent, holistic approach to the definition of "security" and the scope of the securities laws. State courts have uniformly applied some form of this analysis to all cases, except those involving stock after the *Landreth* decision.\(^ {262}\) The vitality of this mode of analysis in the state courts is evidenced by the continuing use of the *Howey* and risk capital tests,\(^ {263}\) and the state courts' sublimation of the literalist aspects of the *Reves* opinion.\(^ {264}\)

Viewed in the most favorable light, the literalist approach taken by the Supreme Court is motivated by institutional concerns such as federalism, separation of powers and electoral accountability, which do not constrain state courts.\(^ {265}\) As traditional common-law courts of general jurisdiction, state courts share law-making authority with state legislatures. Therefore angst over judicial activism, and consequent constraining devices such as a plain meaning approach to statutory interpretation, are unnecessary in the state court context.

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258. Previous commentators have argued for precisely this role for the *Howey* or *Howey*-like tests. See, e.g., Carney, *supra* note 44, at 315 (arguing that economic realities test is overarching doctrine allowing courts to determine that securities laws will apply where they ought to); Page, *supra* note 53, at 296-99 (constructing global definition for all securities based on *Howey* test). See also Chang, *supra* note 1, at 413-32 (arguing that "security" should be viewed as overarching concept to be applied by courts to determine whether transactions involving instruments otherwise included in enumerated categories should be subject to securities laws).

259. See discussion *supra* notes 137-39 and accompanying text.

260. See *supra* Part III. B. and Part III. C.

261. See *supra* Part III. A.

262. See *supra* Part III. A.

263. See *supra* Part III. C.

264. See *supra* Part III. B.

265. See *supra* Part IV. A.
It is therefore a mistake to sacrifice a deliberative development of a state’s securities law because of a slavish assimilation of these federal concerns under an uncritical policy of uniformity.

Furthermore, the logic underlying the policy of harmony does not extend to a requirement that federal and state securities laws be coextensive. Other than an argument against regulation in general, there is no reason why one state should not feel free to expand the scope of its securities act to an instrument not regulated by any other state or by the federal government. In fact, unrestrained by an uncritical policy of harmonization, state courts will offer the benefits of experimentation, offering a greater multiplicity of experiences from which to draw in both state and federal development of securities regulation. Perhaps the single greatest example of the dynamic of this experimentation is the risk capital test. The most important innovation in the developing economic realities approach, the risk capital test was first proposed by the California Supreme Court. It was then adopted by the Ninth Circuit.

Of greatest concern, however, are the indications that the literal approach taken by the federal courts to the securities laws stem from a lack of interest and a search for facile solutions. If the federal courts are looking to literalism for easy solutions, either because they are uninterested in the policy considerations behind the “sale of business” doctrine or the factual nuances behind the label “general partnership,” state courts may be forced to look to their history and become again the primary forum for the protection of investors.

266. See supra Part IV. B.
268. See, e.g., Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc. 583 F.2d 426 (9th Cir. 1978) (applying risk capital test to notes); El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir. 1974) (applying risk capital test to investment contracts), cert. denied, 419 U.S. 900 (1974).