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TAKING STOCK OF STOCK AND THE SALE OF CLOSELY HELD CORPORATIONS: WHEN IS STOCK NOT A SECURITY?

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In recent years courts have begun to question the applicability of the antifraud provisions of state and federal securities laws to transfers of controlling interests in closely held corporations. The emerging majority view is that a sale of one hundred percent of the stock in a closely held corporation, coupled with a transfer of active management, constitutes a "sale of business," rather than a "sale of securities," and, therefore, does not trigger the protective provisions of the securities laws. In this article Professor Hazen presents an overview of the law relating to interests that constitute a "security," analyzes the case law dealing with the "sale of business" doctrine, and proposes a legal framework for determining when shares of stock should not be treated as securities. He concludes that corporate stock, unless it is stripped of all its traditional attributes, falls within the statutory definition of a security, and that courts should refrain from manipulating the definition of "security" in an effort to exempt transfers of ownership of closely held corporations from the antifraud provisions of the securities laws.

I. INTRODUCTION

There has been a great deal of judicial and scholarly interest in the securities laws as they apply to publicly held corporations. Although federal and state securities laws contain several exemptions from their registration requirements for the financing of closely held corporations,¹ the general antifraud

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1. *See, e.g.*, SEC Regulation A, 17 C.F.R. § 230.251-256 (1981); SEC Regulation D, 47 Fed. Reg. 11,262 (1982) (to be codified at 17 C.F.R. § 230.501-506). *See generally* J.W. HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 (7A Securities Law Series, rev. ed. 1981); PRACTICING LAW INST., 386 CORPORATE LAW & PRACTICE COURSE HANDBOOK SERIES, PRIVATE AND SMALL BUSINESS OFFERINGS (1982); Benton & Gunderson, *Venture Capital Financings and Exemptions from Registration Under the Securities Act of 1933: Section 4(2), Rule 146, and Rule 242*, 21 SANTA CLARA L. REV. 23 (1981); Boltz & Wickersham, *Small Business and the SEC: Recent SEC Initiatives to Facilitate Small Business Financing*, 55 CALIF. ST. B.J. 246 (1980); Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139; Green & Brecher, *When Making a Small Public Offering Under Regulation A (with forms)* (pts. 1 & 2), 26 PRAC. LAW., Mar. 1, 1980, at 25, Apr. 15, 1980, at 41; Miller, *The Participation of National Banks in Private Placements of Corporate Securities*, 13 NEW ENG. L. REV. 63 (1977); Moore & Balman, *Regulation D: Revised Federal Rules for Limited & Private Offerings of Securities*, 53 OKLA. B.J. 810 (1982); Savage, *Compliance Requirements for Small Issuers Under the Federal Securities Act and the Connecticut Uniform Securities Act*, 55 CONN. B.J. 489 (1981); Soraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC. REG. L.J. 3 (1980); Thornforde, *Exemptions from SEC Registration for Small Businesses*, 47 TENN. L. REV. 1 (1979); Note, *Securities Regula-*

provisions of the securities acts apply to both exempt securities and exempt transactions.² For example, whenever a securities sale or purchase is made, the parties are held to full disclosure so long as the transaction meets the minimal jurisdictional requirements of the federal act.³ A number of recent cases have focused on the question of the applicability of the securities laws to transfers of controlling interests in closely held corporations.⁴ The majority of decisions on point have held that the sale of one hundred percent of the stock coupled with active management constitutes the sale of a business and is thus not included in the definition of a security.⁵ This article will explore what has become known as the "sale of business" doctrine. The thesis to be presented is that although there may be good reasons for excluding such transactions from the securities laws, this goal should not be accomplished by manipulating the definition of "security."

After briefly defining the problem, the article will present an overview of the law relating to what constitutes a security, and will then turn to cases that deal specifically with the "sale of business" doctrine and the issue of when shares of stock are not securities. Finally, the article concludes that contrary to the current trend of the case law, corporate stock, unless it is contractually stripped of all its traditional attributes, falls within the statutory definition of a security.

II. THE PROBLEM DEFINED

When a sole proprietor decides to sell his or her business, the only constraints in terms of full disclosure lie within the confines of common-law

tion: Improved Financing Alterations for Small Issuers, 38 WASH. & LEE L. REV. 875 (1981); Note, *Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Business*, 23 WM. & MARY L. REV. 73 (1981); see also Barron, *Control and Restricted Securities*, 8 SEC. REG. L.J. 261 (1980); Buckley, *Small Issues Under the Ontario Securities Act, 1978: A Plea for Exemptions*, 29 U. TORONTO L.J. 309 (1979); Cheek, *Exemptions Under the Proposed Federal Securities Code*, 30 VAND. L. REV. 355 (1977).

2. 15 U.S.C. §§ 77c, 77d, 78c(12) (1976 & Supp. IV 1980); see also UNIF. SECURITIES ACT § 402, 7A U.L.A. 638 (1958). For discussion of the scope of the general antifraud provisions, see generally A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* (1982); 5B A. JACOBS, *THE IMPACT OF RULE 10B-5* (rev. ed. 1980); Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case* (pt. 2), 55 VA. L. REV. 199, 201-16 (1969); Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978); Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 HOUS. L. REV. 231 (1976).

For cases explicitly applying rule 10b-5 to closely held corporations, see, e.g., *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Brown v. Ivie*, 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982); *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1980); *Occidental Life Ins. Co. v. Pat Ryan & Assocs.* 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

3. The federal act is called into play whenever the parties to a purchase or sale of a security utilize an instrumentality of interstate commerce. 15 U.S.C. §§ 771(2), 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1981). There is no requirement of a minimum amount in controversy and even an intrastate phone call has been held to suffice. *E.g.*, *Loveridge v. Dreagoux*, 678 F.2d 870 (10th Cir. 1982); *Dupuy v. Dupuy*, 511 F.2d 641 (5th Cir. 1975); *Aquionics Acceptance Corp. v. Kollar*, 503 F.2d 1225 (6th Cir. 1974); *Kerbs v. Fall River Indus.*, 502 F.2d 731 (10th Cir. 1974); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

4. See *infra* notes 54-110 and accompanying text.

5. See *infra* note 54 and accompanying text.

fraud. Generally, there is no affirmative duty to disclose information known by the seller but not known by the purchaser unless some special relationship exists between them.⁶ Because the purchaser of a business generally operates at arm's length vis-à-vis the seller, and because no special or fiduciary relationship exists between them, the transaction will be governed by the doctrine of *caveat emptor*. Accordingly, unless the purchaser can show an intentional, or in some cases a reckless affirmative misrepresentation, he will probably be without a remedy under common law unless express warranties were included in the transaction.

On inroad upon the rule of *caveat emptor* has arisen in instances when the manager of a business has withheld material facts. For example, a director of a closely held corporation selling his shares was held liable for describing the company as a "gold mine" but failing to disclose that it was on the verge of bankruptcy.⁷ The court held that defendant's special position as a corporate director created the duty to convey this information in a face-to-face transaction,⁸ although normally corporate directors do not have a duty to convey information to the general public.⁹ In another, more familiar example, the United States Supreme Court held it to be actionable nondisclosure that the hidden purchaser of plaintiff's shares was a director of the company.¹⁰ These cases may be construed as imposing more stringent standards of disclosure when the interests transferred are those of a closely held business that has been incorporated. This interpretation both has merit and is logical, because the seller is by definition also an insider. Such decisions, however, represent the most liberal extensions of the common law and thus may depart from the mainstream analysis. It follows that the injured purchaser is well advised to look elsewhere for protection.

When asking whether the sale of all the stock in a corporation constitutes a sale of a "security," there is necessarily raised the more general question whether the mere act of incorporation should change the obligations of an owner when he decides to sell the business. The decision to incorporate brings to the business several attributes that are deemed advantageous to the owner; otherwise, incorporation would not be undertaken.¹¹ It is not unreasonable to attach corresponding burdens, especially when the corporate form triggers the need for the increased protection of others.

6. See generally W. PROSSER, HANDBOOK ON THE LAW OF TORTS § 106 (4th ed. 1971).

7. Ragsdale v. Kennedy, 286 N.C. 130, 209 S.E.2d 494 (1974). The court reasoned: "The rule is that even though a vendor may have no duty to speak under the circumstances, nevertheless if he does assume to speak he must make a full and fair disclosure as to the matters he discusses." *Id.* at 139, 209 S.E.2d at 501.

8. The court observed that "it is settled law in this jurisdiction that when the circumstances make it the duty of the seller to apprise the buyer of defects in the subject matter of the sale known to the seller but not to the buyer, suppression of the defects constitutes fraud." *Id.* at 140, 209 S.E.2d at 501.

9. See e.g., Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924); Dovy v. Cory, 1901 A.C. 477.

10. Strong v. Repide, 213 U.S. 419 (1909).

11. See Hazen, *The Decision to Incorporate*, 58 NEB. L. REV. 627 (1979).

III. THE DEFINITION OF SECURITY—AN OVERVIEW¹²

When Congress drafted the Securities Act of 1933¹³ it was quite mindful of the effects of the Great Depression and the stock market crash of 1929. The legislative history of the Act makes it clear that the primary congressional intent was to foreclose the types of fraud in the capital stock and bond markets that had aggravated the severity of the crash.¹⁴ It therefore cannot be doubted that the Act was intended to cover traditional investment instruments such as stocks and bonds. Additionally, in order to guard against sharp promoters, the legislation eschewed a narrow definition of security and was drafted to cover a variety of other investment schemes that invite similar abuses.

The definition of "security" that is set out in section 2(1) of the Securities Act of 1933 is thus an expansive one:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹⁵

The definitions contained in the Securities Exchange Act of 1934¹⁶ and the state "blue sky" laws¹⁷ are substantially the same.¹⁸ It is ironic, indeed, that

12. There is voluminous literature on the basic question of what constitutes a "security" under federal and state securities legislation. See, e.g., Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971); Mofsky, *Some Comments on the Expanding Definition of "Security"*, 27 U. MIAMI L. REV. 395 (1973). For a recent article in support of a restrictive definition, see Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U.L. REV. 225 (1982).

Accordingly, the discussion that follows is not exhaustive and will describe the relevant cases only to the extent necessary to discuss the specific issue at hand—whether sale of stock in a small business should be covered by the securities laws.

13. Pub. L. No. 22, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a-77aa (1976 & Supp. IV 1980)).

14. See, e.g., 1 L. LOSS, *SECURITIES REGULATION* 121-29 (2d ed. 1961); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

15. 15 U.S.C. § 77b(1) (1976).

16. 15 U.S.C. § 78c(a) (1976 & Supp. IV 1980).

17. E.g., N.C. GEN. STAT. § 78A-2(11) (1981); see also UNIF. SECURITIES ACT § 401(I), 7A U.L.A. 628 (1958), which provides:

"Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share, investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for guarantee of, or warrant or right to subscribe to or

this definition, which was originally intended to be expansive, is now being used restrictively by many courts to exclude certain closely held stock from the coverage of the Act.

Although all the relevant definitions expressly include the term "stock," most of the case law interpreting the statutory definition of "security" emphasizes the concept of "investment contract." As will be demonstrated more fully below, many of the cases dealing with the sale of stock as a security borrow heavily from this line of decision. Accordingly, it is necessary to have at least a rudimentary understanding of the "investment contract" rubric.

On the first occasion the United States Supreme Court faced the definitional issue, it focused upon the general character of the investment vehicle in question: a syndicated oil and gas leasehold interest coupled with a drilling contract.¹⁹ In finding the leasehold interests to constitute securities, the Court looked to three factors. First, the Court considered the terms of the offer, including the degree of syndication and the fact that the ownership interest did not carry with it the right to control the day-to-day activities of the business. Second, the Court looked to the plan of distribution and the widespread marketing techniques that were used. Third, the Court scrutinized the economic inducements that the promoters held out to the prospective purchasers.²⁰ These factors alone would not appear to cover most transfers of total control in closely held corporations, because such transfers do not arise in the context of mass-marketing and syndication.

Just three years after the Supreme Court's seminal decision that oil and gas drilling plans are securities, it handed down the landmark decision dealing with the meaning of "investment contract." At issue in *SEC v. W.J. Howe Co.*,²¹ was the subdivision and sale of orange groves. Defendant marketed small tracts of commercial orange groves and also offered a management contract, under the terms of which a management firm controlled by defendant would cultivate, pick, and market the fruits of the purchasers' investment. Although the management contract was not tied to the purchase of the land by the terms of the agreement, the Court noted that the economic realities of the situation revealed a tying of products.²² This de facto tie-in resulted in the

purchase any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period.

18. Compare *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (federal statutory definition construed) with N.C. GEN. STAT. § 78A-2(11) and UNIF. SECURITIES ACT § 401(f), 7A U.L.A. 628 (1958).

19. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), noted in 12 GEO. WASH. L. REV. 494 (1944) and 17 S. CAL. L. REV. 324 (1944).

20. 320 U.S. at 353. The specific economic inducements, marketing techniques, and representations used by a seller of all the stock in a corporation should thus bear heavily upon the determination of the applicability of the securities laws.

21. 328 U.S. 293 (1946).

22. *Id.* at 300. The plots being offered were so small that an owner could not profitably arrange for his own harvesting. Since the land and trees were marketed as a productive asset, there was in fact no real choice but to purchase the management contract. See also *SEC v. Tung Corp. of Am.*, 32 F. Supp. 371 (N.D. Ill. 1940).

purchasers' being asked to make a passive investment, which in turn was sufficient to prompt the Court to characterize the entire package as a security.

In *Howey* the Court established a four-factor test that remains the benchmark in deciding whether a particular transaction involves an "investment contract." In the Court's words, "An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party."²³ In holding defendant's promotional scheme to constitute a security, the Court in *Howey* pointed out that a nominal direct interest in the physical assets of the enterprise, such as actually owning the fruit trees, did not preclude a determination that what was actually marketed and sold was an investment contract. In other words, the purchaser's role as a passive investor, with a significant divorcement of ownership from control of the enterprise, emerges as one key to the *Howey* decision.

In *Howey* the Court also pointed out that the absence of formal certificates, stock, or other traditional indicia of investment did not weaken the finding of a security. This rationale is understandable in light of the statute's express inclusion of "stock" in addition to the concept of an "investment contract." Emphasizing the absence of formality would allow in substance the practices that the Act was designed to eliminate. In light of the broad statutory definition, the Court's view is especially justifiable. It is, however, quite another thing to imply the inverse of the *Howey* ruling and determine that the presence of formal stock does not preclude a finding that the buyer purchased only the assets of the business, thus making the securities laws inapplicable.²⁴ When a business is incorporated, the entrepreneur has decided that the corporate form is advantageous. Hallmarks of incorporation include centralized management and the potential for the separation of ownership from control.²⁵ If the parties choose to structure the transaction in terms of the sale of stock rather than a sale of assets, it is not unreasonable to force them to accept all the consequences of that decision, including limited exposure²⁶ to federal and state securities laws.

Since the Supreme Court's decision in *Howey*, refinements to the four-factor test have been made. The requirement that the profits be secured "solely" from the efforts of another has been diluted to require that profits be

23. 328 U.S. at 298-99 (bracketed numerals added). The *Howey* test remains in force. *Cf. Marine Bank v. Weaver*, 102 S. Ct. 1220 (1982) (*Howey* cited and distinguished).

A few states, led by California, have adopted a risk capital test as an alternative to the four factors in *Howey*. See, e.g., *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The risk capital test has received little, if any, acceptance in the federal courts. Furthermore, a risk capital analysis does not shed any light upon the problem at hand: whether stock is a security.

24. See *infra* text accompanying notes 54-108.

25. H. BALLANTINE, CORPORATIONS 3 (rev. ed. 1946); *Larson v. Commissioner*, 66 T.C. 159 (1976); Rev. Rul. 79-106, 1979-1 C.B. 448.

26. The exposure is limited because there are significant exemptions for small issues and small issuers. See *infra* text accompanying notes 50-53.

derived primarily or substantially from the efforts of others.²⁷ Accordingly, a security may exist notwithstanding the recognition that efforts of the investor are necessary for the success of the operation, such as in pyramid sales arrangements,²⁸ founder-membership contracts, and customer referral agreements.²⁹ Courts have also included within the term "securities" transactions that were denominated, at least in form, as franchise contracts.³⁰ It is clear, however, that a bona fide franchise agreement is not a security.³¹ Similarly, in most cases a limited partnership interest constitutes a security,³² and with appropriate facts even a general partnership interest has been included in the definition.³³

In all of the foregoing decisions finding a security to exist, the courts emphasized the investor's reliance on the efforts of others to make the transaction a success from his or her point of view. In the case of a transfer of all or substantially all of the stock in a closely held company for which the purchaser is to become the manager of the business, there in fact is no such separation of ownership from control, although the corporate structure provides a ready mechanism for such a separation. Because this purchase is not a passive investment, many courts have found no investment contract—and hence, no security—to exist.³⁴ As will be seen below, the major error in such an analysis

27. *E.g.*, SEC v. Koscot Interplanetary, 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

As the court in *Koscot* explained:

In view of these developments and our analysis of the import of the language in and the derivation of the *Howey* test, we hold that the proper standard in determining whether a scheme constitutes an investment contract is that explicated by the Ninth Circuit in SEC v. Glen [sic] W. Turner Enterprises, Inc., *supra*. In that case, the court announced that the critical inquiry is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." [474 F.2d] at 482.

497 F.2d at 483.

28. *E.g.*, SEC v. Koscot Interplanetary, 497 F.2d 473 (5th Cir. 1974).

29. *E.g.*, Florida Discount Centers v. Antinori, 232 So. 2d 17 (Fla. 1970); State v. Hawaii Mkt. Center, 52 Hawaii 642, 485 P.2d 105 (1971). *But see, e.g.*, Gallion v. Alabama Mkt. Centers, 2892 Ala. 679, 213 So. 2d 841 (1968); Georgia Mkt. Centers v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969).

30. *E.g.*, Mitzner v. Cardet Int'l, 358 F. Supp. 1262 (N.D. Ill. 1973).

31. *E.g.*, Martin v. T.V. Tempo, Inc., 628 F.2d 887 (5th Cir. 1980); Nash & Assocs., Inc. v. Lum's of Ohio, 484 F.2d 392 (6th Cir. 1973); L.H.M., Inc. v. Lewis, 371 F. Supp. 395 (D.N.J. 1974), *aff'd mem.*, 510 F.2d 970 (3d Cir. 1975); Weibolt v. Metz, 355 F. Supp. 255 (S.D.N.Y. 1973); Mr. Steak, Inc. v. River City Steak, 324 F. Supp. 640 (D. Colo. 1970), *modified in amount*, 460 F.2d 666 (10th Cir. 1972); Coleman, *A Franchise Agreement: Not a "Security" Under the Securities Act of 1933*, 22 BUS. LAW. 493 (1967). *See generally* Freeman, *An Analysis of the Franchise Agreement Under Federal Securities Laws*, 27 SYRACUSE L. REV. 919 (1976).

32. *See, e.g.*, Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975); Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (1961).

33. Williamson v. Tucker, 645 F.2d 404, 422-25 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); Pawgan v. Silverstein, 265 F. Supp. 898, 900 (S.D.N.Y. 1967).

34. *E.g.*, King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981); *see infra* text accompanying notes 54-108. *See generally* Comment, *The Sale of a Close Corporation Through a Stock Transfer: Covered by the Federal Securities Laws?*, 11 SETON HALL L. REV. 749 (1981); Comment, *Securities Regulation—Is Stock a Security?*, 30 U. KAN. L. REV. 117 (1981); Recent Decisions, *Securities Regulation—Security Defined*, 30 EMORY L.J. 1212 (1981).

arises in focusing upon the concept of "investment contract" rather than the express statutory inclusion of "stock" as a security.

The refinements of the *Howey* test have not been limited to the factor of the investor's reliance upon the efforts of others. The Court has also elaborated upon the expectation of a profit,³⁵ a critical factor when considering the transfer of a closely held corporation. The decision that comes to bear most closely upon the question of stock as a security in this context is the Supreme Court's ruling in *United Housing Foundation v. Forman*.³⁶ In the *Forman* decision the Court ruled that shares of stock in a cooperative residential housing project did not fall within the definition of "security" under the Act. Mere denomination of the shares as "stock" was not dispositive, although as pointed out above, stock is expressly included in the Act's definition of security. Since the "stock" in *Forman* lacked traditional stock attributes, the Court held that it was not within the statutory definition of stock.³⁷ The Court then went on to examine whether the defendants were marketing investment contracts. On this issue, the Court upheld substance over form and focused upon the economic reality of the investment venture. The decision distinguished resort condominium cases in which an individual might well be induced to purchase the property primarily for investment,³⁸ since the building in question in *Forman* was used as a bona fide primary residence. Although the other criteria of the four-factor *Howey* test may have been met, there was no expectation of a profit, even though rent reductions in terms of profits rebated from commercial properties were, at best, tangential to the stock, and thus the residential lease agreements were properly characterized as residential housing contracts

35. In *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979) the Court touched upon this and other issues. The Supreme Court ruled that a compulsory, noncontributory defined-benefit employee pension plan is not a security within the meaning of the 1933 Act. The Court noted the involuntary nature of the plan and the absence of employee contributions (*i.e.*, no investments of money). These factors strongly negated any inference that a security was involved. The court also noted that when faced with a defined-benefit plan, the payment to the employee upon retirement bears no relation to the employee's contribution in terms of time in service.

Another factor for the *Daniel* Court was the lack of a substantial expectation of profit. Because the largest part of the eventual retirement benefits is derived from the employer's contributions, rather than from reinvestment income derived from the efforts of pension plan managers, the Court held the profit aspects of the plan were too insubstantial to fall within the concept of an investment contract. In addition, the Court focused upon a number of contingencies to the vesting of the plan that rendered any "profit" too speculative to justify a reasonable expectation.

Because of the many factors involved in the *Daniel* decision, however, it cannot be assumed that a pension plan will never be characterized as a security. See Stansbury & Bedol, *Interests in Employee Benefit Plans as Securities: Daniel and Beyond*, 8 SEC. REG. L.J. 226 (1980); see also Tomlinson, *Securities Regulation of Employee Stock Ownership Plans: A Comparison of SEC policy and Congressional Intent*, 31 STAN. L. REV. 121 (1978). For example, a voluntary contribution plan with a variable annuity might well be found subject to the securities laws. Cf. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (variable annuity held to be a security).

36. 421 U.S. 837 (1975).

37. *Id.* at 851.

38. *Id.* at 851-52; see Aldrich v. McCulloch Properties, 627 F.2d 1036 (10th Cir. 1980); Rosenbaum, *The Resort Condominium and the Federal Securities Laws—A Case Study in Governmental Inflexibility*, 60 VA. L. REV. 785 (1974); Annot., 52 A.L.R. FED. 146 (1981); see also Williamson v. Tucker, 645 F.2d 404 (5th Cir.), cert. denied, 454 U.S. 897 (1981) (real estate joint venture held to be a security).

rather than as investment contracts.³⁹

In its most recent pronouncement on the subject, the Court used the economic reality test to exclude a bank's certificate of deposit from the operation of the securities laws.⁴⁰ The Court reached that result even through the certificate could properly be classified as a note, which would bring it within the statutory definition.

Employing the economic reality test⁴¹ that was adopted in *Forman*, but at the same time ignoring the factor of profit expectation, some courts have held that the sale of stock in a closely held corporation is not a sale of "securities," especially if it is essentially a transfer of the corporation's assets.⁴² One court has held that the sale of fifty percent of the outstanding shares is not a sale of securities that would subject the transaction to either state or federal securities regulation.⁴³ It may be significant that these decisions, like the most recent Supreme Court pronouncements, have used the economic reality test to restrict coverage of the securities laws, as contrasted to the earlier decisions that used the test to expand the Act's scope in regulating unconventional investments. In these cases the courts have reasoned that since full ownership of a closely held corporation involves neither a pooling of interest nor a common enterprise, the economic reality test requires a finding of no security.⁴⁴ This reasoning, however, ignores two integral aspects of the *Forman* decision. First, *Forman* involved a scheme in which there was no expectation of a profit. In contrast, when purchasing a business, whether or not through stock ownership, the purchaser surely expects a profit. The absence of this expectation in the *Forman* decision was given sufficient treatment in the Court's opinion to render it a substantial factor in the holding. In all the sale of business cases, there is a traditional profit motive. Second, the Supreme Court pointed out in *Forman* that the cooperative housing package presented none of the benchmarks of stock as it is normally defined.⁴⁵ As will be explained more fully below, closely held stock does not fall in the same category, even when there is only one shareholder.

Properly viewed, the facts of *Forman* failed to satisfy two of the four

39. 421 U.S. at 855-58.

40. *Marine Bank v. Weaver*, 102 S. Ct. 1220 (1982); *cf. Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir. 1981) (inquiring into the "economic realities" underlying the commercial/investment dichotomy), *cert. denied*, 455 U.S. 939 (1982); *Union Planters Nat'l Bank v. Commercial Credit Business Loans*, 651 F.2d 1174 (6th Cir.) (loan participation agreement not a security), *cert. denied*, 454 U.S. 1124 (1981); *C.N.S. Enter. v. G. & G. Enter.*, 508 F.2d 1354 (7th Cir.) (discussing how the commercial/investment distinction influences the characterization of short-term notes as securities), *cert. denied*, 423 U.S. 825 (1975); *People v. Syde*, 37 Cal. 2d 765, 235 P.2d 601 (1951) (discussing the "service contract"/"investment contract" distinction). *But see Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) (rejecting the commercial/investment distinction).

41. *See Coffey, supra* note 12; *Hannan & Thomas, supra* note 12.

42. *E.g., Frederiksen v. Poloway*, 637 F.2d 147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981); *see also infra* note 54.

43. *Oakhill Cemetery v. Tri-State Bank*, 513 Supp. 885 (N.D. Ill. 1981).

44. *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981).

45. 421 U.S. at 851 (citations omitted).

Howey investment contract factors: the lack of either a common enterprise or an expectation of profit. By contrast, in the case of the sale of a business, the profit motive is not lacking. The sale of a business, however, does arguably lack the common enterprise element. In a related area, some courts have held that the absence of a common enterprise precludes a finding that a managed commodity or stock brokerage account is, in and of itself, a security.⁴⁶ Nevertheless, a number of courts have found a security to exist on such facts.⁴⁷ It is thus questionable whether the absence of commonality in the sale of a business should be sufficient to tip the balance against the finding of a security. In any event, the most important criticism of the courts' reliance upon the *Howey* factors is that the factors are derived from an interpretation of the statutory term "investment contract," rather than from a proper focus upon the statute's express inclusion of "stock."

The Court in *Forman* made a great effort to emphasize that the "stock" in a housing cooperative is completely different from shares in a business venture, which are the true subjects of the securities acts. In the Court's own words:

In the present case respondents do not contend, nor could they, that they were misled by use of the word "stock" into believing that the federal securities laws governed their purchase. Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock. These shares have none of the characteristics "that in our commercial world fall within the ordinary concept of a security." . . . Despite their name, they lack what the Court in *Tchernin* deemed the most common feature of stock: the right to receive "dividends contingent upon an apportionment of profits." . . . Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.⁴⁸

There is no doubt that stock in a closely held business cannot be classified in such a *sui generis* fashion, unless, of course, it is saddled with a wealth of unusual restrictions and conditions. In fact, closely held stock has all of the attributes that were lacking in *Forman*. The importance of this issue, the statutory concept of "stock," is heightened by the Supreme Court's only passing

46. *Milnarik v. M-S Commodities*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1973), *cert. denied*, 416 U.S. 994 (1974).

47. *See, e.g.*, *Noa v. Key Futures*, 638 F.2d 77 (9th Cir. 1980); *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132 (8th Cir. 1970); *SEC v. International Mining Exch.*, 515 F. Supp. 1062 (D. Colo. 1981).

48. 421 U.S. at 851 (citations omitted).

treatment of the circuit court's "alternative holding" as to the meaning of "investment contract."⁴⁹

IV. THE SALE OF BUSINESS CASES

It is the thesis of this article that although good reasons for excluding the sale of closely held corporations from the securities laws' purview may exist, this goal should be accomplished, if at all, through statutory amendment rather than by a judicial twisting of the statutory definition of "security." By its terms, the 1933 Securities Act exempts from its registration provisions those transactions that do not involve a public offering.⁵⁰ The state "blue sky" laws have comparable exemptions.⁵¹ Similarly, the periodic reporting requirements of the Securities Exchange Act of 1934 apply only to publicly held companies.⁵² Under each of these statutes, however, the general antifraud provisions apply to securities transactions regardless of any exemption from the registration or reporting requirements.⁵³ Clearly, legislatures were aware of the need to ease the burden on issuers and sellers of small amounts of securities. Realizing at the same time the need for some minimum investor protection in small transactions by virtue of the antifraud provisions, the legislatures expressly included "stock" as a security. Many courts seem to have lost sight of this balance.

Over the past several years there has been a flurry of cases dealing with the question whether a sale of an entire business, even though in a stock transaction, is subject to the securities laws. The overwhelming majority of the cases that have squarely faced the issue have held that the sale of one hundred percent of the stock in a closely held corporation is not a security.⁵⁴ Courts

49. *Id.*

50. 15 U.S.C. § 77d(2) (1976); *see also id.* § 77c(b); SEC Regulation A, 17 C.F.R. § 230.251-.256 (1981); SEC Regulation D, 47 Fed. Reg. 11,262 (1982) (to be codified at 17 C.F.R. § 230.501-.506); *supra* note 1.

51. UNIF. SECURITIES ACT §§ 402(b)(1), (9), 7A U.L.A. 640-41 (1958).

52. 15 U.S.C. § 78m(g) (Supp. IV 1980).

53. *See, e.g.*, 15 U.S.C. §§ 77c, 77d, 78c(12) (1976 & Supp. IV 1980); *see also supra* note 2.

54. *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977); *Seagrave Corp. v. Vista Resources*, 534 F. Supp. 378 (S.D.N.Y. 1982); *Reprosystem, B.V. v. SCM Corp.*, 522 F. Supp. 1257 (S.D.N.Y. 1981); *Somogyi v. Butler*, 518 F. Supp. 970 (D.N.J. 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981); *Dueker v. Turner*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979); *Tech Resources v. Estate of Hubbard*, 246 Ga. 583, 272 S.E.2d 314 (1980); *Condux v. Neldon*, 83 Ill. App. 3d 575, 404 N.E.2d 523 (1980); *see also McGrath v. Zenith Radio Corp.*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,841 (7th Cir. May 20, 1981) (accepting but not applying the sale of business doctrine); *Thompson, supra* note 12; *cf. Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 43 (E.D. Mich. 1982) (holding sale of business doctrine inapplicable on facts); *Kane v. Fischbach*, [Current] FED. SEC. L. REP. (CCH) ¶ 98,608 (E.D.N.Y. Mar. 31, 1982) (sale of partnership not subject to the securities laws). *See generally Seldin, When Stock is Not a Security: The "Sale of Business Doctrine" Under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982); *Thompson, The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U.L. REV. 225 (1982); *Comment, The Sale of a Close Corporation Through a Stock Transfer:*

have even gone so far as to hold that the sale of more than fifty percent of a corporation's outstanding stock creates a presumption that the transaction is not a sale of securities which would subject the sale to regulation under the securities acts.⁵⁵ The basic theory of these decisions is that since the purchaser will be actively running the business, there is neither an element of commonality nor a reliance on the efforts of others—two of the four *Howey* factors.⁵⁶ In contrast, only a few of the more recent decisions have held that such a transfer is subject to the securities laws.⁵⁷

In the first case to decide the point, the Fourth Circuit held that the sale of an entire business through a transfer of shares is subject to the antifraud provisions of the federal securities laws.⁵⁸ The court reached this result by looking to the terms of the statutory definition. Defendants claimed that the transaction at issue was in essence a sale of assets, which was a matter of state law. The Fourth Circuit responded with a "strong presumption" of inclusion for instruments such as stock that fall under the literal definition of the statute.⁵⁹ In so ruling the court pointed to a significant factor: the transaction could easily have been structured so as not to involve a security, but the parties chose otherwise.⁶⁰ This literal interpretation of the statute⁶¹ has fallen into disrepute because of what many lower courts have viewed to be the appropriate impact of the Supreme Court's "economic reality" test.⁶² Such a rationale represents an unfortunate misapplication of the doctrine. In all other instances, the economic reality test has been limited to borderline cases rather than extended to instruments that fall literally within the statutory language. This limitation on the use of a pragmatic approach would not be unique under the securities laws.⁶³ A pragmatic analysis, however, generally should not be employed

Covered by the Federal Securities Laws?, 11 SETON HALL L. REV. 749 (1981); Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. U.L. REV. 295 (1980); Recent Decisions *supra* note 34; Note, *Securities Law—Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Law*, 65 MARQ. L. REV. 487 (1982).

55. *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); see *infra* text accompanying notes 79-94; see also *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982). *Contra Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979); *Coffin v. Polishing Machs.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

56. See *supra* text accompanying notes 21-34.

57. *Cole v. PPG Indus.*, 680 F.2d 549 (8th Cir. 1982); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Sterling Recreation Org. Co. v. Segal*, 537 F. Supp. 1024 (D. Colo. 1982) (rejecting the sale of business doctrine under the investment contract test but remanding for factual findings); *Mifflin Energy Sources v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); see also *Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc.*, 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974); *Titsch Printing v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976); cf. *Katz v. Abrams*, 549 F. Supp. 668 (E.D. Pa. 1982) (the sale of business doctrine does not exclude the transfer of all the stock from the UNIFORM COMMERCIAL CODE's definition of security); *Alna Capital Assoc. v. Wagner*, 532 F. Supp. 591 (S.D. Fla. 1982).

58. *Occidental Life Ins. Co. v. Pat Ryan & Assocs.*, 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974).

59. *Id.* at 1261.

60. *Id.* at 1262.

61. *Id.*; see also *Sterling Recreation Org. v. Segal*, 537 F. Supp. 1024 (D. Colo. 1982); *Titsch Printing v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978).

62. See *supra* notes 40-42 and accompanying text.

63. See for example the cases dealing with "non-garden-variety transactions" and prohibi-

when the statute applies by its very terms.⁶⁴

In the first decision to eschew a literal approach to the sale of one hundred percent of a corporation's stock, the court relied on "economic realities" in labeling the transaction a sale of assets rather than of stock.⁶⁵ The court observed that as the purchaser of a liquor store, plaintiff depended solely upon his entrepreneurial efforts for the success of his investment. A later decision, which has been the basis for the mainstream of cases to date, held that in such a case the operative language of the statute is not whether the transaction in question involves "stock," but whether it constitutes a "investment contract" under the *Howey* test and its subsequent refinements.⁶⁶ This shift has been properly described as "a significant expansion of the *Howey* test."⁶⁷ Nevertheless, the rationale has continued to flourish and has been adopted by at least two circuit courts of appeals.⁶⁸

The Seventh Circuit has applied the investment contract analysis to sales of stock on three occasions.⁶⁹ In these cases the court held that the form of the transaction is irrelevant if, in fact, the purchaser is acquiring the entire business and will be the primary manager.⁷⁰ The court rejected an earlier Fourth Circuit decision⁷¹ that read the Supreme Court's decision in *Forman*⁷² to com-

tions against insider short-swing profits under the 1934 Act. 15 U.S.C.A. § 78p n.85 (1981 & Supp. 1982); see *Hazen, The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C.L. REV. 1 (1975).

64. This appears to be the proper approach for defining a security, and has been adopted by the Fourth Circuit. *Coffin v. Polishing Mach.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); see *infra* note 74.

65. *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,965 (D. Colo. Dec. 4, 1975), *aff'd*, 691 F.2d 443 (10th Cir. 1977).

66. *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977).

67. Recent Decisions, *supra* note 34, at 1234 n.117 (1981); see also Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99, 114-15 (1982) (footnotes omitted):

The cases in which shares of stock are not deemed securities present several problems. First, to the extent that some of the opinions imply that the *Howey* criteria must always be met, they are based on a reading of *Forman* which is, as the courts recognize, debatable. As noted earlier, the Supreme Court did not turn to the *Howey* criteria to determine whether the shares were securities *until* it had concluded that the stock did not possess characteristics generally associated with common stock. And, although the Court observed that the criteria of *Howey* have run through all of its decisions, that statement is hardly surprising since all of its previous decisions had involved investment contracts. It is not clear that the Court intended the observation to be interpreted as a requirement that all cases be analyzed by the *Howey* criteria. Moreover, the Court recognized that instruments bearing the name of one of the enumerated classes may well be securities, particularly if they possess the characteristics of the securities whose name they bear. Analyzing all alleged securities under the *Howey* test ignores that admonition.

Second, the reliance on the Court's use of the economic realities of the transaction is another misinterpretation of the Court's opinion in *Forman*.

68. See *supra* notes 54-55. For a more detailed discussion of the facts involved in the relevant cases, see Seldin, *supra* note 54.

69. *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

70. *Canfield*, 654 F.2d at 466.

71. *Coffin v. Polishing Machs.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

72. See *supra* text accompanying notes 36-49.

pel a different result. The Fourth Circuit, in finding that a sale of one half of a corporation's stock was subject to the antifraud provisions of the securities laws, had pointed out that the Court in *Forman* stressed the lack of traditional indicia of stock in the housing co-op interest and therefore held that the transaction was not covered by the Act.⁷³ In contrast, when dealing with the sale of a close corporation, the stock is transferable, is likely to appreciate in value, and carries dividend rights—characteristics that were lacking in *Forman*.⁷⁴ The Seventh Circuit has assailed the Fourth for failing to consider either the economic realities of the transaction or the lack of a common enterprise and reliance on the efforts of others.⁷⁵

Nonetheless, one major problem with the economic reality test for investment contracts should be noted. As applied to the sale of stock, the test eliminates predictability of result. In addition to ignoring the terms of the statutory definitions, this approach is especially questionable in a transaction that the parties have voluntarily chosen to structure as a sale of stock. As noted above, there are many reasons for selecting the corporate form. The protections (or burdens) of the securities laws may be viewed as a necessary by-product of the benefits conferred by limited liability, the ability to separate control from ownership, and the law's recognition of a separate corporate entity as a person.⁷⁶ In *King v. Winkler*⁷⁷ the Eleventh Circuit has recently taken an ad hoc approach to the issue that not only interferes with what would otherwise be a reasonable expectation of the parties at the time of the transaction, but further eliminates any degree of predictability:

It is apparent that the approach used here is not a function of

73. 596 F.2d at 1204; see *supra* text accompanying note 48.

74. The court of appeals observed in *Coffin*, 596 F.2d at 1204:

We do not believe that *Forman* denies a purchaser of ordinary corporate stock the protection of the federal securities laws simply because he intends to participate in the management of the corporation in which he invests. Both the Securities Act of 1933, 15 U.S.C. § 77b(1), and the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), include "stock" within their definitions of a "security." Thus, when a transaction involves stock, there is a strong presumption that the statutes apply. *Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc.*, 496 F.2d 1255, 1261 (4th Cir. 1974). *Forman* requires us to analyze the substance of a transaction only when the stocks involved do not have the "significant characteristics typically associated with the named instrument." See *Forman*, 421 U.S. 837, 850-51, 95 S. Ct. 2051, 2060, 44 L. Ed. 2d 621.

Absent some showing that ordinary corporate stocks are other than what they appear to be, we need not consider whether an investor partly derive his profit partly from his own efforts. The test drawn from *SEC v. Howey Co.*, 328 U.S. 293, 298, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946), applies to interests not easily recognized as securities in the capital market. It does not apply to stock that comes within the clear language of the securities acts. The court in *Forman*, for example, applied the *Howey* test only after deciding that the shares under consideration were not like ordinary capital stock. See *Forman* 421 U.S. 837, 850-53, 95 S. Ct. 2051, 44 L. Ed. 2d 621; *Bronstein v. Bronstein*, 407 F. Supp. 925, 929-30 (E.D. Pa. 1976).

75. *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147, 1152 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). It has been recognized that these and similar decisions present "close" and "possibly questionable" readings of the facts. *Seldin, supra* note 54, at 648.

76. For most purposes, whether by way of statute or caselaw, a corporation is a "person." See H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* § 80 (2d ed. 1970).

77. 673 F.2d 342 (11th Cir. 1982).

numbers. A sale of less than 100% of the stock might not be covered by the Acts. A sale of 100% of the stock can be covered by the Acts. The number of sellers and purchasers will not necessarily control the outcome. Once the literal words of the statute are abandoned for an "economic realities" test, each case must be evaluated on its own facts to determine if the transaction, though within the letter of the statute, is not within its spirit nor the intent of the lawmakers. *Forman*, 421 U.S. at 849, 95 S. Ct. at 2059. Although there will necessarily be close cases at the margin of this principle, this case comes clearly into focus. The purchasers were buying and the seller was selling a business. The stock was the vehicle of transfer. The purchasers' expectation of profit would come from their own efforts, not those of others. This was not a security transaction or investment contract intended to be governed by the Federal Securities Acts.⁷⁸

A logical but unrealistic extension of the court's reasoning might be to exclude a stock payment plan to the single manager of a business although the bulk of stock is held by passive investors. Such a result would seem to be in conflict with both the language and focus on the securities laws, and shows the dangers inherent in the Eleventh Circuit's method of analysis.

It may well be, however, that these transactions involving transfer of all the stock and management of a closely held business are too local in nature to warrant federal involvement. If that is so, Congress should respond by amending the jurisdictional provisions of the securities laws to provide an explicit exemption for what in essence is the sale of a business. Alternatively, Congress could set out an exclusion for transactions that have a *de minimis* effect upon interstate commerce, the securities markets, or securities transactions in general. In the absence of such legislative reform, the courts should veer away from the ad hoc method of analysis proffered by the Seventh and Eleventh Circuits.

Unfortunately, courts have taken the next logical step suggested by the approach of the Eleventh Circuit and have held that a transaction involving the sale of one-half of a company's stock is not subject to the securities laws. In *Oakhill Cemetery v. Tri-State Bank*⁷⁹ plaintiff purchased from defendant 500,000 shares, which constituted fifty percent of the company's outstanding stock. This sale was coupled with an agreement transferring control of the company to the purchaser. The transaction was followed by the company's repurchase of the remaining 500,000 shares from a nonparty to the lawsuit.⁸⁰ The court telescoped the two-step transaction into the sale of one hundred percent of the company's stock and then held that the transfer was not subject to the securities laws under the sale of business doctrine.⁸¹ Although clearly establishing that a sale of less than all of the stock when coupled with control

78. *Id.* at 346.

79. 513 F. Supp. 885 (N.D. Ill. 1981).

80. Plaintiff also purchased a note that the court held was subject to the securities laws, but the claim was nevertheless dismissed for failure to have alleged the requisite deception. *Id.* at 890-91.

81. *Id.*

could satisfy the sale of business doctrine, the decision also presented the holding that the transaction lacked the element of deception necessary to state a claim under SEC rule 10b-5.⁸² The nondeception ruling may be a significant reflection of the court's true concern, since it involved a finding that the case really concerned claims of corporate mismanagement, which is generally a matter of state law rather than an issue touching the federal domain of investor protection.⁸³ A third ground for the court's dismissal of the complaint in *Oakhill* was that plaintiff lacked standing to sue under rule 10b-5.⁸⁴ These other holdings would have been sufficient and weaken the precedential effect of the court's reliance on the sale of business doctrine.

The *Oakhill* ruling has been criticized even by those who support the sale of business doctrine.⁸⁵ Furthermore, the result in *Oakhill* had been eschewed in several earlier cases.⁸⁶ In fact, the first case to recognize an implied right of action under rule 10b-5 involved a similar fact pattern.⁸⁷ In any event, the *Oakhill* decision does stand as evidence of the willingness of one court to extend the approach adopted by the Eleventh Circuit. This form of reasoning is particularly troubling in light of the general types of abuses that have been known to occur in the transfer of controlling interests of less than all of a corporation's stock.⁸⁸ Elimination of the protection afforded by the general antifraud provisions of the securities laws further exacerbates the problem. In spite of these difficulties, however, the Eleventh Circuit in *King v. Winkler* and the district court in *Oakhill* laid the groundwork for an increasingly large body of law.

That groundwork for such an interpretation under the sale of business doctrine was most recently expanded by the Seventh Circuit Court of Appeals in *Sutter v. Groen*.⁸⁹ The court not only reaffirmed its earlier position,⁹⁰ but

82. *Id.* at 890-92. On the issue of deception, see *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Healey v. Catalyst Recovery*, 616 F.2d 641 (3d Cir. 1980); *Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979); *Kidwell v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *O'Brien v. Continental Ill. Nat'l Bank & Trust Co.*, 593 F.2d 54 (7th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Wright & Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

83. See generally Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980); Hazen, *Corporate Mismanagement and the Federal Securities Act's Antifraud Provisions: A Familiar Path with Some New Detours*, 20 B.C.L. REV. 819 (1979); Krendl, *The Progeny of Santa Fe v. Green: An Analysis of the Elements of a Fiduciary Duty Claim Under Rule 10b-5 and a Case for a Federal Corporation Law*, 59 N.C.L. REV. 231 (1981).

84. 513 F. Supp. at 890 n.9.

85. See Seldin, *supra* note 54, at 677 ("The court's opinion contained no justification for so expanding the doctrine"); Comment, *Acquisition of Business Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. U.L. REV. 295, 311-12 (1980).

86. *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979); *Coffin v. Polishing Machs.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 866 (1979); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

87. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

88. See generally Hazen, *Transfers of Corporate Control and Duties of Controlling Shareholders—Common Law, Tender Offers, Investment Companies—And a Proposal for Reform*, 125 U. PA. L. REV. 1023 (1977).

89. 687 F.2d 197 (7th Cir. 1982).

90. *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637

expanded the scope of the doctrine by announcing a rebuttable presumption that it would apply to any transaction involving the transfer of more than fifty percent of a corporation's common stock. In the words of Judge Posner:

If, as in this case (the complaint alleges that Sutter owns 70 percent of the common stock of Happy Radio), the purchaser already has, or by the purchase in question acquires, more than 50 percent of the common stock of the corporation, his purpose in purchasing the stock will be presumed to have been entrepreneurship rather than investment. The presumption can be rebutted by showing that the purchaser's main purpose was investment.⁹¹

The court justified this presumption by emphasizing the focus of the securities acts upon a shareholder's investment as opposed to his or her entrepreneurial interest in the business.⁹²

It is no doubt true that there is a significant difference between a shareholder as investor and a shareholder as proprietor.⁹³ This distinction does not mean, however, that the two interests cannot overlap, especially when entrepreneurs voluntarily select a certain form for embodying their proprietary interest. The court's view in *Sutter* of the economic reality of the transaction devolves upon the separation of ownership from control as the benchmark of an investment interest in a corporate enterprise.⁹⁴ In finding no such separation of the facts before it, the court glossed over the formal separation that necessarily follows from the use of the corporate form.⁹⁵ Furthermore, when less than one hundred percent of the stock is transferred, a variety of restrictions arise on the majority shareholder's ability to exert total control because of fiduciary duties owed to the minority shareholders.⁹⁶ The "more than fifty percent" presumption adopted by the court fails to take account of this significant limitation on the shareholder's control, which creates a separation of ownership from control—albeit not a total one.

Under the guise of an economic reality test the Seventh Circuit thus refused to base its analysis upon the plain meaning of the statute. Judge Posner's justification for rejecting a literal interpretation of the statute emphasizes the use of the economic reality test in order to best capture the spirit of the law.⁹⁷ While this means of interpretation is appropriate in the face of ambigu-

F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981); see *supra* notes 69-75 and accompanying text.

91. 687 F.2d at 203.

92. *Id.* (relying in part upon A. BERLE & G. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* (1932); Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 789 n.14 (1972)).

93. See Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391.

94. See *supra* note 92.

95. See *infra* text accompanying notes 115-18.

96. See generally F. O'NEAL, *OPPRESSION OF MINORITY SHAREHOLDERS* (1975).

97. "[I]n interpreting statutes as in interpreting Biblical commands, the letter killeth but the spirit giveth life." 687 F.2d at 200. The *Sutter* court also relied upon the Supreme Court's ruling in *Marine Bank v. Weaver*, 102 S. Ct. 1220 (1982), that a certificate of deposit is not covered by the securities laws. In so ruling, the Court held that the certificate of deposit lacked the characteristics of long-term debt instruments, in part because the statutory definition included notes but excluded

ity, it seems totally inappropriate when the stock in question contains all the traditional attributes of stock as that term is used in the statutory definition.⁹⁸

In addition to the questionable statutory construction employed by Judge Posner in *Sutter*, there are also very serious problems in properly applying the presumption. First, does the presumption apply regardless of whether the complaining party is the purchaser or seller? The court's opinion makes no such distinction. In the absence of such a distinction, one who has selected the corporate form and seeks to assert a claim against the purchaser could discover that his or her antifraud remedies are dependent upon the intent of the purchaser as to whether the sale of the stock was an entrepreneurial or investment transaction. The problem could arguably be solved by focusing upon the intent of the person asserting the securities claim. Nonetheless, this solution does not appear to be fully satisfactory, because it still fails to provide the predictability of result that is an absolute necessity for planners of corporate transactions.

An even more important problem with the presumption announced in *Sutter* is that by definition, most tender offers would be presumed to be entrepreneurial and thus not covered by the securities laws, since the ultimate objective of a tender offer is control of the target business rather than investment. The provisions of the Williams Act amendments⁹⁹ to the Securities and Exchange Act of 1934 belie any claim that tender offers for control do not implicate the securities laws. Although a defeated tender offeror does not have a claim for damages under the general antifraud provisions of the Williams Act,¹⁰⁰ the Act affords other protections, including full disclosure and a right to bring an action for injunctive relief.¹⁰¹ Furthermore, the general antifraud provision of the Act¹⁰² is applicable regardless of the size of tender offer involved. It is thus clear that the "more than fifty percent" presumption cannot properly be applied in cases involving either the shareholders of a target company or the tender offeror. Moreover, these problems with the rule announced by the Seventh Circuit Court of Appeals in *Sutter* are not unique to the tender offer method of corporate takeover. It is beyond question that the securities laws apply to mergers that involve purchases of control.¹⁰³ It would thus be anomalous to apply the rule to such transactions. Although it is, of course, possible to limit application of the presumption to closely held companies, the regulation provided by the securities acts of transactions transferring control

short-term commercial paper. *Id.* at 1224-25. The *Weaver* case stands for the proposition that "certificates of deposit," although included in the statutory definition of "security," are not securities in some contexts.

98. See *supra* text accompanying notes 48-49.

99. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976 & Supp. IV 1980)).

100. See *Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977).

101. *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 372 (6th Cir. 1981); *Whittaker Corp. v. Edgar*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,483 (N.D. Ill. Jan. 25, 1982).

102. 15 U.S.C. § 78n(e) (1976).

103. See, e.g., *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

in other instances would seem to contradict even the more limited use of the doctrine with close corporations. In sum, in the farthest reaching decision to date, the Seventh Circuit Court of Appeals has distorted by way of undue expansion the sale of business doctrine, a doctrine that is questionable in its own right.

A recent court of appeals decision to depart from the *King*, *Oakhill*, and *Sutter* rationales was delivered by the Second Circuit in *Golden v. Garafalo*.¹⁰⁴ This currently developing split between the Seventh and Eleventh Circuits on one side, and the Second, Fourth, and Eighth Circuits¹⁰⁵ on the other, would appear to make the issue ripe for Supreme Court review. The *Golden* decision quite properly limits the *Howey-Forman* economic reality test to cases involving "unusual" or "unique" instruments. The court explained:

We think the term "stock" in the definition of "security" in the '33 and '34 Acts should be read to include instruments, such as these, which have the characteristics associated with ordinary, conventional shares of stock. There was little reason for the drafters to use words such as "stock," "treasury stock" or "voting-trust certificate," unless their intention was to include all such instruments as commonly defined. If an "economic reality" test were intended, reference to such specific types of instruments, and common variations of them, would have been inappropriate because a substantial portion of each class of instrument would, in fact, not be within the definition. We believe that Congress intended to draft an expansive definition and to include with specificity all instruments with characteristics agreed upon in the commercial world, such as "debentures," "stock," "treasury stock" or "voting-trust certificates." Catch-all phrases such as "investment contract," were then included to cover unique instruments not easily classified. If the "economic reality" test were to be the core of the definition, only general catch-all terms would have been used.

We are cited to no legislative history contradicting this perfectly plausible reading of the statutory language. The House Report accompanying the bill which became the '33 Act indicated that the definition of "security" was intended to cover "the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933). We regard this statement as support for the proposition that instruments ordinarily regarded as "stock" are a "security," notwithstanding that the underlying transaction involves a transfer of control. This understanding of Congressional intent, moreover, has been almost universally accepted by the courts, the relevant agency and the bar for over 40 years. Only after *Forman* has there been a serious challenge to this reading of the statutes.¹⁰⁶

This analysis seems to be the most justifiable way of dealing with the issue

104. 678 F.2d 1139 (2d Cir. 1982).

105. See *infra* text accompanying note 110.

106. 678 F.2d at 1144.

under the current statutory framework. Although the weight of authority continues to be to the contrary, a few courts have seen the wisdom of the Second Circuit's approach.¹⁰⁷ Both the *Howey* decision and the statutory language treat "investment contract" and "stock" as two distinct definitions.¹⁰⁸ Although undoubtedly the two distinct terms should be read *in pari materia*, they are not synonymous.

The inclusion of "investment contract" in the definition was meant to encompass within the coverage of the securities acts a range of investment devices that create risks similar to those associated with the stock and bond markets.¹⁰⁹ The *Howey* test reflects the elements of such risks in terms of the attributes of the transaction in question. By its very nature, stock in a business enterprise creates at least preexisting contractual rights to attain precisely those attributes. As the *Forman* decision indicates, a pragmatic or ad hoc analysis is appropriate only when (1) the profit motive is lacking and (2) the "stock" does not possess any of the indicia generally associated with corporate shares. Along these lines, the Eighth Circuit Court of Appeals, applying Arkansas law, recently refused to apply the sale of business doctrine in lieu of "the traditional and accepted meaning of the terms 'stock' and 'securities.'" ¹¹⁰

In many cases the transfer of an incorporated sole proprietorship may not involve the type of risks involved in a traditional securities transaction. As observed above, however, in such a case the parties have chosen to structure the transaction in a certain manner with accompanying legal consequences. The question whether the increased burden on judicial time is warranted by federalizing such transactions is no doubt a valid one, but that issue should be addressed upon its own merits, in terms of either additional exemptions or limitations on the jurisdictional provisions of the securities acts. This question should not be answered by manipulating the definition of "security," a practice that in turn encourages abuses by sharp promoters. When the corporate form is selected, the need arises to prevent such potential abuses that are present solely by virtue of the form of the transaction. The next section will consider corporate attributes and ways in which the decision to incorporate in and of itself creates many of the risks that the securities laws were designed to regulate.

V. CORPORATE SHARES AND THEIR ATTRIBUTES

When a sole proprietorship, or any other business, decides to incorporate, it is usually after a careful weighing of relative advantages and disadvantages.¹¹¹ If entrepreneurs opt for the corporate form, they do so in spite of the

107. See *supra* note 57.

108. In addition to *Garafalo*, see *Cole v. PPG Indus.*, 680 F.2d 549 (8th Cir. 1982); *Sterling Recreation Org. Co. v. Segal*, 537 F. Supp. 1024 (D. Colo. 1982); *Dillport*, *supra* note 67, at 114-15.

109. See *supra* note 13.

110. *Cole v. PPG Indus.*, 680 F.2d 549, 556 (8th Cir. 1982).

111. The most frequently cited advantages include:

(1) The capacity to act as a legal unit, to hold property, to contract, to sue and be sued as a distinct entity; (2) limitation of or exemption from individual liability of share-

general wisdom, "When in doubt, don't incorporate."¹¹² In many instances the decision will be made for tax reasons,¹¹³ but will, nevertheless, have substantial impact upon the way in which the business is to be conducted. The planner thus must consider all of the merits and drawbacks before opting for the corporate structure. When making such a closely balanced decision, it is neither unusual nor overly burdensome to expect that certain predictable consequences will follow. As will be demonstrated below, at least under the current statutes, the coverage of the general antifraud provisions of the securities laws should be considered a highly reasonable consequence of incorporation.

Even when the primary reason for the corporate form is to create a tax advantage, there are five structural consequences for the business that follow upon incorporation. First, there is limited liability of the shareholders that renders their shares nonassessable: the investor, or investors, will not be liable beyond the initial investment, even if the business incurs more liabilities than its assets are able to cover. Second, there is continuity of existence, which means, for example, that upon the owner's death the business passes through the estate as a solitary unit, unless the corporation is dissolved and the assets liquidated. Accordingly, when a sole proprietor dies with more than one heir, the control of the business is likely to be split, and even the business itself may be so divided. By contrast, in the case of a corporation, the business will continue, but the identity of its owners will change. Third, corporate shares, unlike interests in a general partnership, are freely transferable.¹¹⁴ The fourth consequence of the corporate form is centralization of management. Because corporation statutes mandate a board of directors¹¹⁵ and certain designated

holders; (3) continuity of existence; (4) transferability of shares; (5) centralized management by the board of directors; (6) standardized methods of organization, management and finance prescribed by corporation acts for the protection of shareholders and creditors, including a more or less standardized system of shareholders' relations, rights and remedies.

H. BALLANTINE, *supra* note 25, at 3; *see also* 1 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 5-7, 10-14 (rev. ed. 1974); 1 F. O'NEAL, *CLOSE CORPORATIONS* § 1.12 (2d ed. 1971); C. ROHLICH, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES* §§ 2.01-.51 (5th ed. 1975); Hazen, *supra* note 11.

112. G. SEWARD, *BASIC CORPORATE PRACTICE* 8 (ALI-ABA rev. ed. 1966):

When in doubt, don't incorporate. Many small corporations are formed inadvisably. The corporate form of doing business is probably disadvantageous for a small new venture. The cost of the privilege of limited liability will probably be too high. Not only is there expense involved in forming and maintaining a corporation which a sole proprietor would not have to pay, but there may be serious tax disadvantages. The double tax on corporate income distributed as dividends makes the corporate form of doing business basically unattractive. Only by taking advantage of the exceptions and the unusual provisions in the law is the corporate form made attractive for the typical small venture. Hence a basic rule: don't incorporate unless the advantages are worth the cost. Time devoted at the outset to determining whether incorporation is advisable, will be well spent.

113. *See* B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (4th ed. 1979); Z. CAVITCH, *TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS* (1974).

114. This factor was one of the classic indicia of stock that was absent in *Forman*. *See supra* text accompanying note 48.

115. The board of directors of a corporation is elected by the shareholders, and it is statutorily vested with directing the management of the business. *See, e.g.*, CAL. CORP. CODE § 300 (West

officers,¹¹⁶ this form necessarily contemplates a centralized management. A correlative aspect of centralized management is flexibility in creating the management infrastructure.¹¹⁷ Although this hierarchy may not in fact exist at any given time in a closely held corporation, it remains an integral part of the corporate charter, a method of enterprise management that is foreign to the small business whether in the form of a sole proprietorship or general partnership.¹¹⁸ The fifth general corporate attribute is flexibility in capitalization—for example, through the use of different classes of stock and debt/equity hybrids such as preferred stock and convertible bonds. Since these types of senior securities generally are not authorized in single-person closely held corporations, this aspect of capital flexibility is not related to the problem now under consideration.

The above five factors are crucial in distinguishing the corporate form of business from the general partnership or sole proprietorship. Significantly, all of these factors were lacking in *Forman*, but most if not all are present in the case of a closely held business. In addition, the corporate form of doing business necessarily creates contractual obligations that do not otherwise exist. It is classic black-letter law that the corporation is a myriad of contractual relationships, including those among the shareholders themselves, between the shareholders and the corporation (which is generally embodied in the share agreement through the articles of incorporation), and between all of the parties and the state.¹¹⁹ These contractual interrelationships create an element of common enterprise even in a one-person corporation. The corporation exists under the law as a separate entity with its own inherent powers,¹²⁰ regardless

Supp. 1982); DEL. CODE ANN. tit. 8, § 141 (1974 & Cum. Supp. 1980); N.C. GEN. STAT. § 55-24 (1975); MODEL BUSINESS CORP. ACT § 35 (1977).

116. *E.g.*, DEL. CODE ANN. tit. 8, § 142 (1974 & Cum. Supp. 1980); N.C. GEN. STAT. § 55-44 (1975); MODEL BUSINESS CORP. ACT. § 50 (1977).

117. This result can be accomplished, for example, through the delegation of managerial authority to committees. *See, e.g.*, MODEL BUSINESS CORP. ACT. §§ 35, 42 (1977).

118. Both the limited partnership and the "Massachusetts" business trust afford similar separation of ownership from control. Both of these methods of dividing a business are generally held to involve securities. *See Williamson v. Tucker*, 645 F.2d 404, 417-425 (5th Cir. 1981) (considering the impact of reliance upon efforts of others in transforming a partnership interest into a security); *see also Freedman, An Analysis of the Franchise Agreement Under Federal Securities Laws*, 27 SYRACUSE L. REV. 919 (1976). *See generally Long, Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO. L. REV. 581 (1972).

119. H. BALLANTINE, *supra* note 25, § 18.

120. This characteristic has been recognized from the inception of corporate law:

These artificial persons are called bodies politic, bodies corporate . . . or corporations: of which there is a great variety subsisting, for the advancement of religion, of learning, and of commerce; in order to preserve entire and forever those rights and immunities, which, if they were granted only to those individuals of which the body corporate is composed, would upon their death be utterly lost and extinct.

. . . .

After a corporation is so formed and named, it acquires many powers, rights, capacities, and incapacities, which we are next to consider. Some of these are necessarily and inseparably incident to every corporation As, 1. To have perpetual succession. This is the very end of its incorporation: for there cannot be a succession for ever without an incorporation; and therefore all aggregate corporations have a power necessarily implied of electing members in the room of such as go off. 2. To sue or be sued, implead or be impleaded, grant or receive, by its corporate name, and do all other acts as

of whether such powers are exercised at any particular time. It is a discrete unit that not only presents the separation of ownership from control, which is an element of a "security," but also a number of inchoate qualities that duplicate the elements of the *Howey* test for finding an investment.

In determining whether a particular ownership interest is a security, many courts have come to view the presence of a common enterprise as a predominant factor.¹²¹ This consideration, of course, is one of the four items emphasized by the Supreme Court in *Howey*.¹²² The "common enterprise" analysis focuses upon a finding that the investor's participation be pooled in some way with that of others, or be dependent upon the participation of another who also shares the investment risk. A number of courts have relied upon the commonality requirement as a means of excluding pure service contracts. This result can best be understood by illustration. When faced with the question whether a managed individual brokerage account is a security, some courts have found the absence of a common enterprise to compel a negative answer.¹²³ The result has been based on reasoning that the customer's funds were not pooled with those of another, and further that the investment advisor was viewed as merely providing a service. In contrast, other courts have held that the investment advisor's interest—by way of sales commission and management fee—in the success of the investment decisions presented sufficient vertical commonality to find the investment account itself to be a security.¹²⁴ These cases thus do not require an actual pooling of funds, and could easily be extended by analogy to the common enterprise between the sole shareholder and the separate corporate entity.

Even under a strict view of the requirement that there be a common enterprise, shares of stock in the one-person corporation would seem to qualify for treatment as a security. Since the corporate form does create a separate legal entity, except in cases of sham or other gross abuse, the law treats the single owner and his corporation as two distinct persons.¹²⁵ This structural independence creates contractual and fiduciary obligations between the own-

natural persons may. 3. To purchase lands, and hold them, for the benefit of themselves and their successors; which two are consequential to the former. 4. To have a common seal. . . . For, though the particular members may express their private consent to any acts, by words, or signing their names, yet this does not bind the corporation: it is the fixing of the seal, and that only, which unites the several assents of the individuals. . . . 5. To make by-laws or private statutes for the better government of the corporation; which are binding upon themselves, unless contrary to the laws of the land, and then they are void.

1 W. Blackstone, Commentaries *467, *475-76. See generally H. BALLANTINE, *supra* note 25, ch. X; H. HENN, *supra* note 76, § 80.

121. See, e.g., *supra* note 46.

122. See *supra* text accompanying note 23.

123. Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978); Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972); Wasnowic v. Board of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), aff'd mem., 491 F.2d 752 (3d Cir. 1973), cert. denied, 416 U.S. 994 (1974).

124. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); see also Booth v. Peavey Co. Commodities Servs., 430 F.2d 132 (8th Cir. 1970) (private remedy for churning a commodity account is permitted under the Securities Act of 1933).

125. See generally H. BALLANTINE, *supra* note 25, §§ 118-120, at 287-90; H. HENN, *supra* note 76, § 258, at 508-09.

er-manager and the corporation. Because the success of the business affects both the owner and the corporate entity, the common enterprise requirement is satisfied. Use of the corporate form also requires different conduct and results in different consequences than would be the case with an unincorporated sole proprietorship: compliance with corporate formalities such as shareholders' meetings, taxation of the corporate franchise, and state stock transfer taxes are among those differences. It does not seem inappropriate to include among those differences compliance with the antifraud provisions of the securities laws, at least in the absence of an express statutory exclusion.

The concept of the one-person corporation exists in a certain tension with that of the pure corporate form, and courts have long been aware of the potential for abuse.¹²⁶ It would seem anomalous to increase the potential for abuse by excluding the transfer of shares from the ambit of the securities laws. It is well recognized that the corporate franchise is a privilege conferred by the state, which frequently requires the imposition of controls to prevent abuses.¹²⁷ It is thus not novel to maintain that selection of stock as a means of ownership should carry with it the regulatory provisions adopted to prevent abuses in connection with that type of investment vehicle.

Most of the potential abuses by the one-person corporation that are cited when imposing legal limitations are directed towards the protection of creditors who may suffer loss because of the owner's limited liability.¹²⁸ Taking advantage of the corporate form thus insulates the owner from a significant risk generally associated with private enterprise. To give this protection on the one hand, and on the other to deny to prospective purchasers the protections that appear to exist on the face of the securities laws, simultaneously gives the owner the advantage of corporateness vis-à-vis creditors and the advantage of noncorporateness with regard to purchasers of his ownership interest.¹²⁹ This accommodation is especially unnecessary in light of the readily available alternative structure for any sale of a business in the form of a straight sale of assets.

When there is a transfer of control in a closely held business, there are several interests that need to be protected. In control transfers of corporations with minority shareholders the law imposes safeguards against abuses by the selling majority shareholder.¹³⁰ As noted above, these provisions may be viewed as signaling the need for the additional protections of the securities

126. See, e.g., Note, *One-Man Corporations—Scope and Limitations*, 100 U. PA. L. REV. 853 (1952).

127. "The privilege of being and acting as a corporation is nonetheless a grant by the state merely because the state prescribes in a general corporation law certain conditions upon which it may be acquired by all applicants." H. BALLANTINE, *supra* note 25, at 64.

128. See Note, *supra* note 126.

129. In other areas when deemed appropriate, Congress has acted expressly to allow for noncorporate treatment of closely held corporations. One such example is Subchapter S of the Internal Revenue Code, which allows for partnership-type tax treatment for qualifying corporations. I.R.C. §§ 1371-1379 (Supp. IV 1980). Congress could make similar concessions for closely held corporations in the federal securities laws.

130. See Hazen, *supra* note 88.

laws when dealing with the sale of less than all of a corporation's stock. In addition, certain protections are afforded to creditors.¹³¹ Creditors and existing shareholders are two constituencies traditionally given special protection by corporate law.¹³² There even exist protections for future shareholders.¹³³ The securities laws extended additional protections to present and future shareholders to the extent that they are investors as well as proprietors or owners of the business.¹³⁴ It is thus not unreasonable to provide protection for purchasers of the stock beyond those that already exist at common law.

As far as the creditors of a corporation are concerned, the choice between a sale of stock or transfer of assets may have a significant impact on their rights against the debtor, and similar distinctions should exist in securities law issues as they relate to a purchaser's rights against the seller. Under the line of decisions finding the sale of one hundred percent of a company's stock not to be a security under the sale of business exception, the seller is able to exact a double benefit. First, the seller can take advantage of limited liability vis-à-vis creditors and, under what is now the majority view, at the same time deny the purchaser of the business the protection of the antifraud provisions of the securities laws. Second, in structuring the transaction, the seller can deny to creditors rights that would otherwise arise under the Uniform Commercial Code's bulk transfer provisions,¹³⁵ which apply to sales of certain assets but not to complete transfer of ownership through the sale of some or all of the corporate stock. In this instance the law recognizes that the choice of a certain form for the transaction should carry with it certain consequences. There is no reason to vary the result with regard to the applicability of the securities laws.

VI. CONCLUSION

The sale of a business is—or at least, should be—a carefully structured transaction. Both the purchaser and seller are free to negotiate the various terms of the transfer, including the ultimate form the transaction will take. Because certainty in planning and predictability of result are important elements of any business deal, leaving the question of the applicability of securities laws to an ad hoc, after-the-fact determination is clearly contrary to this

131. See, e.g., UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 164 (1981).

132. Corporation statutes define the rights of shareholders both in terms of power to control and the right to participate in the proceeds of the business. See, e.g., MODEL BUSINESS CORP. ACT. §§ 15, 32, 58 (1977). These statutes also protect creditors by limiting the director's ability to deplete corporate assets by way of dividends or otherwise. See, e.g., DEL. CODE ANN. tit. 8, §§ 170-174 (1974 & Cum. Supp. 1980); N.C. GEN. STAT. § 55-50 (1975 & Cum. Supp. 1981); MODEL BUSINESS CORP. ACT. § 45 (1977).

133. See, e.g., *San Juan Uranium Corp. v. Wolfe*, 241 F.2d 121 (10th Cir. 1957); *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N.E. 193 (1909), *aff'd*, 225 U.S. 111 (1912). *But see* *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206 (1907).

134. Share ownership brings with it a variety of interests. As an owner of the business, the shareholder has a proprietary interest and correlative rights. As an investor, the shareholder may have concerns such as full disclosure regarding his investment. For further discussion of the shareholder proprietor/investor distinction, see *Hazen*, *supra* note 93.

135. U.C.C. § 6-106 to -111 (1977).

goal. It is much easier for parties to bargain over the form of the transaction if the consequences are clear. The bargaining process then allows them to place a negotiated price on the risks that are so allocated.

The issues discussed above relate to the transfer of a one hundred percent ownership interest in a closely held corporation. The suggestion by some courts¹³⁶ that the transfer of less than one hundred percent of the stock may be within the sale of business exclusion is even more troublesome because of the line-drawing problems which arise in that context. In such a case, the minority interests belie any claim that the transaction is a sale of assets, since at the very least the majority owes fiduciary duties to the minority that owns a portion of those assets.

In sum, for both conceptual and practical reasons, the sale of business doctrine is not the appropriate method for excluding sales of close corporations from the coverage of the securities laws. An explicit legislative enactment to the contrary would, of course, vindicate the concerns of the courts using the sale of business rationale, and such an enactment is the most logical way to implement those policies.

The only reasonable application of the sale of business doctrine under the current statutory framework would be when, as in *Forman*, all the traditional indicia of stock are absent. For example, if the stock of a corporation were clearly nontransferable, and if profits were to be paid out in salary for services rendered rather than reinvested (thus precluding appreciation of the value of the stock), then the *Forman* decision might justify a finding that the stock is not in fact stock. This hypothetical, however, represents the aberrational case and does not reflect the facts in any of the sale of business cases decided to date. In the typical sale of business through stock, the antifraud provisions of the securities laws should thus apply.

136. *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982); *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); see also *supra* text accompanying note 55.