

## St. John's Law Review

---

Volume 57  
Number 3 *Volume 57, Spring 1983, Number 3*

Article 5

---

July 2012

### The Applicability of the Federal Securities Laws to Transfers of Stock Appurtenant to the Sale of a Business--The Golden Opportunity Lost: *Golden v. Garafalo*

Donald E. Miehl

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

---

#### Recommended Citation

Miehl, Donald E. (1983) "The Applicability of the Federal Securities Laws to Transfers of Stock Appurtenant to the Sale of a Business--The Golden Opportunity Lost: *Golden v. Garafalo*," *St. John's Law Review*. Vol. 57 : No. 3 , Article 5.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol57/iss3/5>

This Comment is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact [selbyc@stjohns.edu](mailto:selbyc@stjohns.edu).

# COMMENTS

## THE APPLICABILITY OF THE FEDERAL SECURITIES LAWS TO TRANSFERS OF STOCK APPURTENANT TO THE SALE OF A BUSINESS—THE *GOLDEN OPPORTUNITY LOST: GOLDEN V. GARAFALO*

Comprehensive regulation of the securities industry began with the enactment of the Securities Act of 1933<sup>1</sup> and the Securities and Exchange Act of 1934<sup>2</sup> (the Acts). Collectively, the Acts

---

<sup>1</sup> Ch. 38, § 1, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1976 & Supp. IV 1980)).

<sup>2</sup> Ch. 404, § 1, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1976)). Prior to the '33 and '34 Acts, legislation regulating securities transactions included the English Companies Act of 1929, 19 & 20 Geo. 5, ch. 23, the Mail Fraud Act, ch. 321, 35 Stat. 1130 (1909) (see 18 U.S.C. §§ 1341, 1342 (1976)), the Interstate Commerce Commission laws governing securities issued by common carriers, see Transportation Act, ch. 91, § 439, 41 Stat. 494 (1920) (codified as amended at 49 U.S.C. § 20a (1976 & Supp. IV 1980)), as well as state Blue Sky legislation, see, e.g., Fraudulent Practices In Respect to Stocks, Bonds and Other Securities Act, ch. 649, § 352-359-a, [1921] N.Y. Laws 1989 (codified as amended at N.Y. GEN. BUS. LAW §§ 352-359-h (McKinney 1968 & Supp. 1981-1982)). For a comparison of the English Companies Act of 1929 and the Securities Act of 1933, see Hanna & Turlington, *The Securities Act of 1933*, 28 ILL. L. REV. 482, 499-502 (1933).

Passage of the '33 and '34 Acts was a response to the inability of individual states to regulate interstate traffic of securities in the "boom and bust" period of the 1920's. See M. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 5-14 (1970). The states were powerless to prohibit securities fraud perpetrated outside their own borders. The '33 Act eliminated this loophole by abrogating the protection afforded to sales made in interstate commerce if the particular securities were sold in violation of state laws. H.R. REP. NO. 85, 73d Cong., 1st Sess. 10 (1933). Thus, the '33 Act requires that securities intended for interstate commerce be registered with the Securities and Exchange Commission. See 15 U.S.C. §§ 77e, 77f (1976 & Supp. IV 1980). The Act also proscribes fraud and misrepresentation in the sale of securities. *Id.* § 77q (1976). The '34 Act, on the other hand, requires that any national securities exchange making use of the mails or any means of interstate commerce register with the Securities and Exchange Commission (SEC). *Id.* §§ 78e, 78f. The Act also includes, *inter alia*, margin requirements, *id.* § 78g (1976 & Supp. IV 1980), restrictions on borrowing by members, brokers, and dealers, *id.* § 78h (1976), and a prohibition against manipulation of security prices, *id.* § 78i.

Federal regulation of securities transactions continued after the '33 and '34 Acts with

were designed to protect the unwary investor from fraud by compelling full and fair disclosure by public corporations of information related to the issuance and trading of instruments<sup>3</sup> commonly considered to be securities.<sup>4</sup> A number of transactions, however,

the enactment of the Public Utility Holding Company Act of 1935, ch. 687, §§ 1-33, 49 Stat. 803 (codified as amended at 15 U.S.C. §§ 79-79z-6 (1976 & Supp. IV 1980)) (protects investors, consumers and the general public from securities fraud, excessive charges to subsidiary public utility companies, obstruction of state regulation, and inefficiency by public utility holding companies), the Trust Indenture Act of 1939, ch. 411, §§ 301-328, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa-77bbbb (1976)) (protects investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest), the Investment Company Act of 1940, ch. 686, §§ 1-53, 54 Stat. 789 (codified as amended at 11 U.S.C. §§ 72, 107; 15 U.S.C. §§ 80a-1 to -52 (1976 & Supp. IV 1980)) (protects the national public interest and the interest of investors from lack of adequate information when dealing with securities issued by investment companies), and the Investment Advisers Act of 1940, ch. 686, § 201-221, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to -21 (1976 & Supp. IV 1980)) (mandates registration of investment advisers).

<sup>3</sup> See *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977) (purpose of '34 Act is to supplant caveat emptor doctrine for a policy of full disclosure); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (purposes of '33 Act are "to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing"); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (purpose of '33 Act is to protect investors through the requirement of "full disclosure by issuers of securities"); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (purpose of federal securities laws is to maintain a high level of ethical standards in the securities field). In *Wilko v. Swan*, 346 U.S. 427 (1953), the Supreme Court emphasized that the Securities Act of 1933 was "[d]esigned to protect investors," and to prevent fraud by requiring full disclosure by issuers, underwriters, and dealers regarding the nature of securities sold in interstate and foreign commerce. *Id.* at 431 (footnote omitted); see *A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 40 (1941) (essential purpose of '33 Act is to protect investors). Some of the abuses in the securities markets that prompted the enactment of the '33 Act included the institution of "dummy directors" whose sole function was to provide "snobbery appeal," the failure to provide adequate information to prospective investors, the abuse of the proxy mechanism by self-perpetuating directorships, and "insider" trading for personal gain. 1 L. LOSS, *SECURITIES REGULATION 19-20* (1961 & Supp. 1962).

<sup>4</sup> The '33 Act defines "security" as follows:

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

(1) The term "security" means any note, stock, treasury stock, bond, . . . investment contract, . . . 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 U.S.C. § 77b(1) (1976). The '33 and '34 Acts' definitions of a security are virtually indistinguishable and have been accorded the same meaning by the Supreme Court. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 556 n.7 (1979). One commentator has defined a security as a "transaction whose characteristics distinguish it from the generality of transactions so as to create a need for the special fraud procedures, protections, and remedies provided by the securities laws." Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 373 (1967); cf. Fitz-Gibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the*

have not qualified for the protection afforded by the Acts.<sup>5</sup> In particular, courts increasingly have recognized the sale-of-business doctrine, which removes from the purview of the federal securities laws any sale of assets and stock in a corporation over which the purchaser intends to assume management and exert control.<sup>6</sup> Re-

---

*Financial Markets*, 64 MINN. L. REV. 893, 919 (1980) ("A security is a financial instrument eligible to participate in a public market.").

<sup>5</sup> The '33 Act itself exempts several transactions from registration, including those undertaken by any person other than an issuer, underwriter, or dealer, and those undertaken by an issuer but which do not involve a public offering. 15 U.S.C. § 77d (1976 & Supp. IV 1980). In addition, the courts have considered several instruments to be outside the scope of the federal securities laws. *E.g.*, *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 (1975) (shares of stock in a cooperative housing project); *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819, 829 (N.D. Tex. 1981) (standby commitment obligating federal credit union to purchase Government National Mortgage Association securities); *Hackford v. First Sec. Bank*, 521 F. Supp. 541, 553-56 (D. Utah 1981) (range company stock proposed for sale by bank as trustee). One district court, in holding that notes tied to the prime rate were not securities, ventured that "a great deal of information would be required in order to allege jurisdiction whenever a claim was based on an instrument that falls in the 'gray area' between a clearly commercial and clearly investment instrument." *LaSalle Nat'l Bank v. Arthur Andersen & Co.*, 531 F. Supp. 702, 706-07 (N.D. Ill. 1982); *see Canadian Imperial Bank of Commerce Trust Co. v. Fingland*, 615 F.2d 465, 470 (7th Cir. 1980).

<sup>6</sup> *See, e.g.*, *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982) (private sale of all stock in a heating and air conditioning business); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465-66 (7th Cir. 1981) (sale of 100% of stock in a machine-parts corporation); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,966, at 96,054 (10th Cir. 1977) (sale of 100% of stock in a liquor business); *Anchor-Darling Indus., Inc. v. Suozzo*, 510 F. Supp. 659, 661, 666 (E.D. Pa. 1981) (sale of controlling shares in three closely held corporations); *Tech Resources, Inc. v. Estate of Hubbard*, 246 Ga. 583, 272 S.E.2d 314, 316-17 (1980) (sale of three corporations accomplished by pledge of all the shares of capital stock). *See generally Seldin, When Stock is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 BUS. LAW. 637, 644-56 (1982) (discussion of recent sale-of-business cases).

In *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981), the Seventh Circuit determined that the sale of 100% of the assets and stock of a marina corporation did not fall within the ambit of the federal securities laws because, *inter alia*, "[t]he stock . . . merely was passed incidentally as an indicia of ownership of the business assets sold . . ." *Id.* at 1151-52. Additionally, in *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378 (S.D.N.Y. 1982), the purchaser acquired a substantial portion of the outstanding shares of stock in a publicly traded corporation, with the head of the purchaser corporation becoming the chairman of the board of the seller corporation. *Id.* at 380, 383. The chairman intended to rely upon present management for daily operations, and asserted that the acquisition of stock was for investment purposes. *Id.* at 380. The court found that the purchaser owned the business and controlled the resources and management, and that the chairman had the power to hire new employees or fire existing officers. *Id.* at 383-84. Thus, the court held that since the shares of stock were acquired as an indicia of ownership, and not for investment purposes, the federal securities laws did not apply. *Id.*; *see SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). *But see Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255, 1263 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974).

cently, however, in *Golden v. Garafalo*,<sup>7</sup> the Second Circuit, rejecting the sale-of-business doctrine, held that conventional shares of a close corporation which possess the characteristics commonly associated with stock are securities within the meaning of the Acts, notwithstanding the purchaser's intention to manage and control the business.<sup>8</sup>

In *Golden*, the plaintiffs purchased 100 percent of the outstanding stock of the defendant's ticket brokerage corporation, intending to manage the business directly.<sup>9</sup> The transfer was effectuated by a sale of shares, rather than assets, because the corporation's leasehold rights to office space were nonassignable.<sup>10</sup> The purchasers subsequently brought an action under the federal securities laws,<sup>11</sup> alleging that the defendant had misrepresented the value of the shares of stock.<sup>12</sup> The plaintiffs also pleaded common-law breach of contract, breach of a restrictive covenant agreement, fraud, and violation of a state securities statute.<sup>13</sup> The United States District Court for the Southern District of New York dismissed the action, concluding that, under the sale-of-business doctrine, the shares were not securities within the meaning of the Acts.<sup>14</sup>

---

<sup>7</sup> 678 F.2d 1139 (2d Cir. 1982).

<sup>8</sup> *Id.* at 1144. The court determined that there was little reason for the framers of the '33 and '34 Acts to use terms such as "stock," "treasury stock," or "voting-trust certificate," unless they intended to include the common definitions of those instruments. *Id.* The court opined that Congress intended to draft an expansive definition and "to include with specificity all instruments with characteristics agreed upon in the commercial world . . ." *Id.* Catch-all phrases such as "investment contract" were added, noted the *Golden* court, to cover unique instruments that are not easily classified. *Id.*

<sup>9</sup> *Id.* at 1140.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*; see 15 U.S.C. §§ 77q, 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1981). Collectively, these provisions proscribe fraud, deception, and nondisclosure in transactions involving securities, where an instrument of interstate commerce, the mails, or a national securities exchange is utilized. See *supra* notes 1-3 and accompanying text.

<sup>12</sup> 678 F.2d at 1140.

<sup>13</sup> *Golden v. Garafalo*, 521 F. Supp. 350, 352 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

<sup>14</sup> 521 F. Supp. at 358. The district court found that the "protective purpose of the federal legislation is not implicated" because the stock was not publicly traded and the plaintiffs did not entrust their capital to an investor hoping to reap a profit. *Id.* Judge Conner reasoned that if the federal securities laws did apply, "the transfer of any conceivable item" would be within the purview of the Acts as long as the transfer was structured as the purchase and sale of the stock of a corporation and the stock was held out as an asset of the corporation. *Id.* The federal laws should not apply, concluded the district court, because they "were not designed to usurp the common law where the reality of the transaction is the transfer of a tangible item for the use of the purchaser." *Id.*

On appeal, a divided Second Circuit panel reversed,<sup>15</sup> holding that the federal securities laws were applicable to transactions involving conventional stock in business corporations, notwithstanding the purchaser's intent to assume total ownership and control of the business.<sup>16</sup> Judge Winter, writing for the majority,<sup>17</sup> initially discussed the tripartite "economic reality" test enunciated by the Supreme Court in *SEC v. W.J. Howey Co.*,<sup>18</sup> a decision that forms one component of the sale-of-business doctrine. The "*Howey* test," which is used to ascertain the existence of an investment contract within the meaning of the '33 and '34 Acts,<sup>19</sup> examines whether there is an investment in a common venture, premised upon a reasonable expectation of profits, to be derived from the entrepreneurial or managerial efforts of others.<sup>20</sup> According to the *Howey* Court, if the transaction at issue satisfies all three criteria, an investment contract within the meaning of the Acts will be deemed present and the federal securities laws thus will apply, regardless of the name attached to the particular instrument.<sup>21</sup>

Turning to the second basis of support for the sale-of-business

---

<sup>15</sup> 678 F.2d at 1140.

<sup>16</sup> *Id.* The SEC submitted an amicus curiae memorandum to the *Golden* court, stating its position that the sale of a business through the transfer of a controlling stock interest is a sale of securities within the meaning of the federal securities laws. See [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,453 (1982). The Commission argued that the district court decision was in conflict with both the letter and spirit of the '33 and '34 Acts, and thus abridged the protections afforded to buyers of common stock under those laws. *Id.* at 92,677. The Commission then emphasized that the term "security" is defined broadly in both the '33 and '34 Acts to include any "stock." *Id.*

<sup>17</sup> The majority consisted of Circuit Judges Newman and Winter. Senior Circuit Judge Lumbard filed a dissent.

<sup>18</sup> 328 U.S. 293, 301 (1946).

<sup>19</sup> The *Howey* Court initiated the "economic reality" test in order to determine whether the offering of units in a citrus grove development, together with a "service contract" for cultivating, marketing and remitting the net proceeds to the investor, was an "investment contract" within the definition of a security in the Acts. *Id.* at 299-300; see *Williamson v. Tucker*, 645 F.2d 404, 417-23 (5th Cir.) (purchase of joint venture interests in a parcel of undeveloped real estate held to be an investment contract), *cert. denied*, 102 S. Ct. 396 (1981); *United Am. Bank v. Gunter*, 620 F.2d 1108, 1118-19 (5th Cir. 1980) (purchase of participation interest in a note held not to be an investment contract); *Peyton v. Morrow Elec., Inc.*, 587 F.2d 413, 414-15 (9th Cir. 1978) (employment contracts involving investment of manager's services and a stock purchase held not to be investment contracts); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 139-46 (1971).

<sup>20</sup> 678 F.2d at 1141; see *Tew & Freedman, In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407, 409-35 (1973).

<sup>21</sup> See 328 U.S. at 301.

doctrine, the Second Circuit observed that *United Housing Foundation, Inc. v. Forman*<sup>22</sup> requires that a "two-part, seriatim test" be used, rather than an automatic application of the *Howey* test, to determine whether shares of stock are "securities" within the meaning of the Acts.<sup>23</sup> Interpreting *Forman*, the court declared that the "economic reality" test of *Howey* need only be applied to ascertain whether a stock is an investment contract, and thus a "security" within the meaning of the Acts, if the shares do not possess the characteristics of conventional corporate stock.<sup>24</sup> The *Golden* court then stated that the legislative history of the Acts evidenced congressional intent to include in the term "stock," instruments, such as those transferred in *Golden*, "which have the characteristics associated with ordinary, conventional shares of stock."<sup>25</sup> If the "economic reality" test routinely were applied to determine whether conventional stock should fall within the ambit of the Acts, reasoned the court, uncertainty as to the precise scope of the Acts would be created, thereby generating "slippery legal and factual issues."<sup>26</sup> Finally, the court exhibited a pervasive fear of future applications of the sale of business doctrine, focusing upon its elusiveness as a legal concept.<sup>27</sup> Judge Winter predicted that if the doctrine's "intent to manage the corporation" standard were adopted, it would lead to countless issues of mixed fact and law.<sup>28</sup> Had Congress wished to narrow the protection of the Acts by

---

<sup>22</sup> 421 U.S. 837 (1975).

<sup>23</sup> 678 F.2d at 1144. In *Forman*, the Supreme Court identified the following five "common features of stock": (1) receipt of dividends contingent upon profitability; (2) negotiability; (3) the ability to be "pledged or hypothecated"; (4) voting rights proportionate to percentage of ownership; and (5) the potential to appreciate in value. 421 U.S. at 851, cited in *Golden v. Garafalo*, 521 F. Supp. 350, 353 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982). The plaintiffs in *Forman* were tenants who purchased shares of stock in a state subsidized housing cooperative. 421 U.S. at 841. Because the shares of stock lacked the five "common features of stock," the Court held that they were not "stock" within the meaning of the '33 and '34 Acts. *Id.* at 851; see also *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967).

<sup>24</sup> 678 F.2d at 1144. *But see* Brodsky, *When Sale of Stock is Not Sale of Security*, N.Y.L.J., Sept. 3, 1981, at 1, col. 1.

<sup>25</sup> 678 F.2d at 1144; see *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 865 (1975) (Brennan, J., dissenting). *But see* Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. U.L. REV. 295, 315 (1980) (to be considered a security, stock exhibiting "traditional characteristics" must be accompanied by "inducements to purchasers of further development").

<sup>26</sup> 678 F.2d at 1145.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* Exemplary of the potential for mixed questions of law and fact is *Reprosystem, B.V. v. SCM Corp.*, 522 F. Supp. 1257, 1273-75 (S.D.N.Y. 1981), wherein the court relied

expressly adopting the sale-of-business doctrine, concluded the majority, it undoubtedly would have done so.<sup>29</sup>

Judge Lumbard dissented, asserting that the majority misconstrued *Forman* by holding that once an instrument is found to possess the common characteristics of corporate stock, the application of the "economic reality" test is foreclosed. The two parts of the *Forman* opinion, argued Judge Lumbard, were structural and not substantive, since the Court merely was responding to the circuit court's alternate grounds for its own decision.<sup>30</sup> In addition, the dissent criticized the majority's reliance upon Supreme Court authority to support the view that "ordinary stocks" should be treated as "securities" under the Acts,<sup>31</sup> noting that the cases cited by the majority actually favor a more restrictive interpretation of the scope of the federal securities laws.<sup>32</sup> With respect to the particular plaintiffs involved in the case, Judge Lumbard reasoned that they did not need the protection of the securities laws because they themselves were capable of protecting their investment.<sup>33</sup> Finally, Judge Lumbard discounted the majority's concern that adoption of the sale-of-business doctrine would allow the application of the '33 and '34 Acts to turn upon uncertain factors, observ-

---

upon evidence of the purchaser's intent to manage the business in order to conclude that the negotiated sale of the defendant's stock and assets in its operating subsidiaries did not involve a "security" within the purview of the Acts. *Id.* at 1274. In *Golden*, the defendant, Garafalo, entered into a consulting agreement with the plaintiffs whereby Garafalo would provide consulting services to the ticket brokerage business for \$100 per day, with such services not to exceed 150 days during 1981. 678 F.2d at 1147 (Lumbard, J., dissenting). The purchasers were, however, to operate the business as they saw fit. *Id.* (Lumbard, J., dissenting).

<sup>29</sup> 678 F.2d at 1147.

<sup>30</sup> *Id.* at 1148 (Lumbard, J., dissenting); see *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). Judge Lumbard reasoned that the *Forman* Court applied a two-part test simply in response to the Second Circuit's holding on alternate grounds, see *Forman v. Community Servs., Inc.*, 500 F.2d 1246, 1252-55 (2d Cir. 1974), *rev'd sub nom.* *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975), namely, that the cooperative shares fell within the literal meaning of "security" in the '33 and '34 Acts, and that the shares constituted an "investment contract" under the *Howey* test. 678 F.2d at 1148 (Lumbard, J., dissenting). Judge Lumbard then posited that the *Forman* Court neither required the application of a two-part test nor foreclosed an examination of the economic reality of the transaction once a determination was made that an instrument possesses the common characteristics of corporate stock. *Id.* (Lumbard, J., dissenting); see Seldin, *supra* note 6, at 665-69 (*Forman* read to support the proposition that an economic reality test is always appropriate).

<sup>31</sup> 678 F.2d at 1148-49 (Lumbard, J., dissenting).

<sup>32</sup> *Id.* (Lumbard, J., dissenting).

<sup>33</sup> *Id.* at 1149 (Lumbard, J., dissenting) (citing Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 249 (1974)).



ing that courts which regularly apply the doctrine experience no undue difficulties.<sup>34</sup>

The Second Circuit's decision in *Golden* comports with the generally accepted view that the federal securities laws are to be construed flexibly in order to protect the investing public from fraud and nondisclosure.<sup>35</sup> Inquiry into the legislative history of the federal securities laws, and consideration of relevant Supreme Court precedent, however, support the position that an extension of federal protection is not warranted in a typical sale-of-business transaction. In atypical or problematic situations, where the intent and status of the parties is unclear, it is suggested that the Ninth Circuit's "managerial efforts" standard be utilized to determine whether the federal securities laws are applicable to the transaction in question.

#### THE FEDERAL SECURITIES LAWS AND CONGRESSIONAL INTENT

The *Golden* court concluded that if the legislature were discontented with the current scope of the Acts' protection, it would move to remedy the situation.<sup>36</sup> It is submitted, however, that the framers of the federal securities laws already have expressed their intent to exclude transactions from the Acts' protection when a purchaser obtains control over the business.<sup>37</sup> Indeed, the '33 Act specifically was aimed at protecting those who possess a mere "symbol of ownership"<sup>38</sup> while the power and responsibility remain in the hands of a distinct controlling group.<sup>39</sup> Moreover, the Act

---

<sup>34</sup> 678 F.2d at 1149 (Lumbard, J., dissenting). Judge Lumbard asserted that "[n]one of the courts that have found the sale of a business not to be the sale of a security have experienced unusual difficulties in reaching that conclusion." *Id.* (Lumbard, J., dissenting).

<sup>35</sup> See *Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *Wolf v. Weinstein*, 372 U.S. 633, 652 n.19 (1963); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

<sup>36</sup> 678 F.2d at 1147. The Second Circuit treated the legislative history of the Acts as ambiguous, noting that "Congress may have had good reason to rely on conventional commercial and legal criteria" for classifying instruments with commonly agreed upon characteristics of "stock," *id.* at 1145, and for "leaving 'economic reality' to govern only the catch-all phrase 'investment contract' in cases involving unusual or unique instruments," *id.* at 1146. These references to the ambiguity of the legislative history of the Acts seemingly fail to support the *Golden* court's opinion that Congress intended to include within the meaning of the Acts "all instruments with characteristics agreed upon in the commercial world . . ." *Id.* at 1144.

<sup>37</sup> See *infra* note 40.

<sup>38</sup> 77 CONG. REC. 2955 (1933) (statement of Rep. Rayburn).

<sup>39</sup> *Id.*

was designed to ensure that investors who purchase shares of stock from an issuing company are provided with reliable information.<sup>40</sup> Neither of these congressional concerns is implicated in the factual context of *Golden*. There, the purchasers obtained control over the ticket brokerage business after the parties themselves, each represented by counsel, reached a basic agreement on terms,<sup>41</sup> and the fraud allegedly perpetrated on the plaintiffs did not emanate from the "reticence of financiers,"<sup>42</sup> but from the misrepresentations of the seller himself.

In contrast to the '33 Act, the '34 Act focuses upon the regulation of stock exchanges and the activities of brokers and dealers.<sup>43</sup> Again, it is apparent that these concerns are not relevant to the arrangement at issue in *Golden*. The typical sale-of-business transaction does not involve a stock market,<sup>44</sup> and the stocks are transferred from seller to buyer without the aid of a securities broker or dealer.<sup>45</sup>

The limited scope of the federal securities laws also is evi-

<sup>40</sup> In the House debate on the '33 Act, Representative Sam Rayburn, the sponsor of the bill, elucidated the need for full disclosure:

We have, on the one hand, 18,000,000 passive citizens having no actual contact with their companies; on the other hand, a few hundred powerful managers directing and controlling the destinies of the companies and the physical properties which they own. The owners of these symbols are entitled to know what the symbols represent. Those who are interested in purchasing these pieces of paper have the right to demand information as to the actual condition of the issuing company. . . . These managers are truly trustees. One of their duties as trustees is to furnish security owners, in being and in prospect, with reliable information. This bill has been drawn to enforce that responsibility.

*Id.* Representative Rayburn identified the purpose of the '33 Act to be the protection of these "18 million owners of symbols." *Id.* See generally 1-11 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahan eds. 1973); Long, *Introduction to Student Symposium: Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 96, 103 & n.29 (1974) (securities laws were intended to protect the public from unsound investments of all kinds).

<sup>41</sup> 678 F.2d at 1147 (Lumbard, J., dissenting).

<sup>42</sup> 77 CONG. REC. 2955 (1933) (statement of Rep. Rayburn).

<sup>43</sup> See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 128 n.9 (1973). Prior to the 1929 stock market crash, the financial community was largely self-regulated and strongly opposed to governmental intervention in the daily operations of the stock exchange. *Id.* Despite this opposition, however, and the enormity of the task, Congress deemed it necessary to the national public interest to eliminate abuses in the securities industry through government regulation. *Id.*; see *supra* note 3 and accompanying text.

<sup>44</sup> *E.g.*, *King v. Winkler*, 673 F.2d 342, 343 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 461 (7th Cir. 1981); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966, at 96,054 (10th Cir. 1977).

<sup>45</sup> In *Golden*, the sale was arranged through the respective parties' attorneys. *Golden v. Garafalo*, 521 F. Supp. 350, 351 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

denced by the inclusion of a caveat, "unless the context otherwise requires," in both the '33 and '34 Acts.<sup>46</sup> Case law has interpreted this clause as alluding both to the transactional context of the instrument in question and to later references to particular instruments in the statute itself.<sup>47</sup> It is indeed arguable that the context of the transaction in *Golden* "requires" that the transferred "stock" be removed from coverage under the Acts. The intention of the purchasers was to acquire a business and use its assets,<sup>48</sup> and their decision to buy was made without relying upon the advice of others. As sophisticated business persons and proprietors of their own ticket brokerage firm, the buyers undoubtedly were aware of the federal securities laws.<sup>49</sup> As the district court noted,

---

<sup>46</sup> 15 U.S.C. § 77b (1976 & Supp. IV 1980); *id.* § 78c(a). The Supreme Court often has quoted one of the most basic maxims of statutory construction in cases involving the federal securities laws, namely, that "[t]he starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring), *quoted in* *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *see also* *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975); *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892) ("[A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.").

<sup>47</sup> *See, e.g.*, *United Am. Bank v. Gunter*, 620 F.2d 1108, 1115 (5th Cir. 1980); *McGovern Plaza Joint Venture v. First of Denver Mortgage Investors*, 562 F.2d 645, 646-47 (10th Cir. 1977); *C.N.S. Enters., Inc. v. G. & G. Enters., Inc.*, 508 F.2d 1354, 1361-63 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1080 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); *Somogyi v. Butler*, 518 F. Supp. 970, 985 (D.N.J. 1981); *Oliver v. Bostetter*, 426 F. Supp. 1082, 1087 (D. Md. 1977); *Seldin*, *supra* note 6, at 652-53; *Sonnenschein, Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 Bus. Law. 1567, 1577-78 (1980); *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, 248 (1982); *Annot.*, 39 A.L.R. FED. 357, 365-66 (1978).

In *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), the court, considering the Acts' "unless the context otherwise requires" language, emphasized the word "requires" and placed the burden of establishing such a context upon the party asserting that the Acts did not apply. *Id.* at 1137-38. For a discussion of the clause as it related to the district court decision in *Golden v. Garafalo*, 521 F. Supp. 350 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982), *see* *Brodsky, When Stock is Not a Security*, N.Y.L.J., Apr. 9, 1982, at 1, col. 1.

One commentator has noted that the *Forman* Court determined that the name of the instrument in question is important in assessing whether it is a "security" in situations where "the underlying transaction [rather than merely the instrument itself] embodies some of the significant characteristics typically associated with (rather than the legal attributes possessed by) the named instrument." *Seldin*, *supra* note 6, at 668. It has been posited that the transactional context of the instrument is one consideration in applying the "economic reality" test because it may engender legitimate reliance upon the benefits and protections of the federal securities laws. *Id.*

<sup>48</sup> 678 F.2d at 1140.

<sup>49</sup> *See id.* In addition to their own business acumen, the purchasers and the seller in

however, the plaintiffs reasonably did not rely upon the protection of the Acts;<sup>50</sup> the concern of both "parties was the transfer of a business, not the sale and purchase of stock."<sup>51</sup> Notably, reliance upon the coverage of the Acts was a critical inquiry in the *Forman* analysis.<sup>52</sup> The plaintiffs in *Forman* were relatively unsophisticated "investors" who purchased stock in a cooperative apartment.<sup>53</sup> The *Forman* Court stated that it was unreasonable to infer that the

*Golden* had the benefit of counsel during the final steps of the negotiations. *Id.* It is interesting to note, however, that even in sales of small businesses, the parties to the transaction generally will not consider whether the securities laws apply. Comment, *supra* note 25, at 316-17. It has been argued that the courts should consider whether there was reliance upon the Acts only if proof of actual reliance upon federal protection can be shown, as when inducements made by a promoter include the claim that the securities laws apply. *Id.* at 317 n.134. See generally Rapp, *The Role of Promotional Characteristics in Determining the Existence of a Security*, 9 SEC. REG. L.J. 26, 45-47 (1981) (purchaser's expectation of investment-type benefits induced by promoter is fundamental element of securities transaction).

<sup>50</sup> *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

<sup>51</sup> *Id.* The district court observed that the parties' structuring of the deal as a stock transfer was "merely a technicality dictated by a provision in a lease." *Id.*; see Seldin, *supra* note 6, at 655-56. The Second Circuit in *Golden* relied upon *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), which rejected the sale-of-business doctrine because the parties "chose to implement their plan for joint ownership by means of a stock transfer rather than a partnership agreement or a sale of assets." 596 F.2d at 1204, *quoted in Golden*, 678 F.2d at 1145. By contrast, the parties in *Golden* were forced to consummate their transaction by a sale of stock because of the nonassignable lease. 678 at 1140.

<sup>52</sup> See 678 F.2d at 1143-44. The *Forman* Court stated:

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51. In *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981), the Seventh Circuit determined that the sale of 100% of the stock of a machine-parts corporation did not give rise to a justifiable assumption that the federal securities laws applied. *Id.* at 466 n.7. Even though the stock had the characteristics of ordinary stock, the court noted that the purchaser acquired total control over those characteristics. *Id.* This meant, for example, that the purchaser could confer dividends on itself at will. *Id.* Thus, the stock was not ordinary capital stock and did not justify the purchaser's reliance upon the Acts. *Id.* But see *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378, 383 (S.D.N.Y. 1982) ("[T]he expectations, subjective intentions and motivations of parties do not determine whether the federal securities laws apply . . ."); Brodsky, *supra* note 47, at 2, col. 2.

<sup>53</sup> 421 U.S. 837, 840 (1975). One commentator has suggested that the unsophisticated investor is the type of investor the Acts were designed to protect. Brodsky, *supra* note 47, at 2, col. 2-3; see Schneider, *The Elusive Definition of a "Security"*, 14 REV. SEC. REG. 981, 985 (1981).

plaintiffs anticipated protection under the '33 and '34 Acts since their shares were purchased solely for housing, rather than investment, purposes.<sup>54</sup> Lack of reliance upon federal protection, in the *Forman* analysis,<sup>55</sup> thus militates against the finding of a "security" within the meaning of the Acts<sup>56</sup> and removes a sale-of-business transaction from their coverage.

Finally, it should be noted that, unlike many other areas of federal regulation,<sup>57</sup> the securities field lacks any indication of congressional intent to preempt applicable state law.<sup>58</sup> In fact, the Supreme Court, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*,<sup>59</sup> observed that any Securities and Exchange Commission rule or practice that was not "germane" to the purposes of the '34 Act<sup>60</sup> "would not appear under the shadow of the federal umbrella; it is, instead, subject to applicable state law."<sup>61</sup> It is suggested that the rationale employed in *Ware* is equally applicable to a sale-of-business situation. Hence, whenever there are adequate remedies available under state law, and particularly when plaintiffs have not relied affirmatively upon the Acts, the limited protection afforded by the federal securities laws apparently is not implicated.<sup>62</sup>

<sup>54</sup> 421 U.S. at 851; see *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

<sup>55</sup> 421 U.S. at 850-61.

<sup>56</sup> See *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 466 n.7 (7th Cir. 1981); cf. *Hirsch v. duPont*, 396 F. Supp. 1214, 1224 (S.D.N.Y. 1975) (an investor who assumes managerial control gains access to information and thus has a lesser need of federal securities law protection), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

<sup>57</sup> See, e.g., *Ridgway v. Ridgway*, 454 U.S. 46, 56-60 (1981) (serviceman's beneficiary designation under a life insurance policy issued pursuant to the Serviceman's Group Life Insurance Act of 1965 prevails over a constructive trust imposed upon the policy proceeds by a state court decree); *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 524-25 (1981) (Employee Retirement Income Security Act of 1974 preempts state law purporting to prohibit workers' compensation benefits from being used to offset pension benefits); *Nyquist v. Mauclet*, 432 U.S. 1, 10 (1977) (regulation of immigration and naturalization is an exclusively federal concern and any state action is preempted); *Townsend v. Swank*, 404 U.S. 282, 286 (1971) ("state eligibility standard that excludes persons eligible for assistance under federal [Aid to Families With Dependent Children] standards violates the Social Security Act" and is preempted).

<sup>58</sup> Section 28(a) of the '34 Act provides that "[t]he rights and remedies provided by this Chapter shall be in addition to any and all other rights that may exist at law or in equity . . ." 15 U.S.C. § 78bb(a) (1976). The Act notes that "[n]othing in this chapter shall affect the jurisdiction of the securities commission . . . of any State . . . insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." *Id.*

<sup>59</sup> 414 U.S. 117 (1973).

<sup>60</sup> *Id.* at 130-31; see *supra* notes 43-45 and accompanying text.

<sup>61</sup> 414 U.S. at 130-31.

<sup>62</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (Court is reluctant to

## SUPREME COURT ANALYSIS OF "SECURITIES" WITHIN THE MEANING OF THE ACTS

The *Golden* court prefaced its discussion of Supreme Court precedent with a recognition that neither *Howey* nor *Forman*, nor the more recent decision in *Marine Bank v. Weaver*,<sup>63</sup> were controlling authority on the sale-of-business doctrine.<sup>64</sup> To be sure, all three cases examined unusual arrangements that did not involve conventional shares of stock. The question to be considered under the sale-of-business doctrine, however, is whether conventional shares of stock, as instruments specifically referred to in the Acts' definition of a "security," invariably should be deemed "securities" without any inquiry into the underlying transaction. Relying largely upon its interpretation of *Forman*, the *Golden* court answered this question affirmatively. Nevertheless, it is submitted that a different analytical approach, drawn from a closer reading of the relevant Supreme Court decisions, is in fact proper. Inquiry into the economic realities of the underlying transaction, the test generated by *Howey* and normally invoked to determine whether unusual arrangements are "investment contracts" within the meaning of the Acts, should be pursued even when transfers of conventional stock are at issue. Such a method of evaluation flows from the language of *Forman*,<sup>65</sup> and is supported further by the preambles to the definitional sections of the Acts, which refer to the transactional context of the particular instrument.<sup>66</sup> This analysis recognizes that all sales of stock are not necessarily sales of securities, and, thus, justifies application of the sale of business

---

override established state policies of corporate regulation dealing with transactions in securities). In analyzing further the concept of reliance, it is submitted that in situations where the instrument need not be registered with the SEC, reliance upon the antifraud provisions of the Acts by the purchaser should not be assumed. The Supreme Court has never considered whether a security could be held to exist for the purpose of the antifraud, but not the registration provisions of the Acts, although the court of appeals in *Daniel* did intimate in dictum that such an anomaly might exist. *Daniel v. International Bhd. of Teamsters*, 561 F.2d 1223, 1240 (7th Cir. 1977), *rev'd*, 419 U.S. 551 (1979); *see Seldin, supra* note 6, at 638 n.3.

<sup>63</sup> 102 S. Ct. 1220 (1982).

<sup>64</sup> 678 F.2d at 1143.

<sup>65</sup> *See Forman*, 421 U.S. at 848. The *Forman* Court specifically objected to employment of a literal approach, rejecting the argument that a "transaction, evidenced by the sale of shares called 'stock,' must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock.'" *Id.* (footnote omitted). The Court cited favorably the economic reality approach taken in *Tcherepnin* and *Howey. Id.*

<sup>66</sup> *See supra* notes 46-47 and accompanying text.

doctrine in a case such as *Golden*.<sup>67</sup>

The Second Circuit also interpreted the sale-of-business doctrine to be more than an incremental extension of *Forman*.<sup>68</sup> It is submitted, however, that the Supreme Court implicitly has sanctioned the doctrine by emphasizing the substance of the transaction and the intent of the parties, while disregarding the form of the transfer and the name attached to the instrument in question.<sup>69</sup> Indeed, the Court has stated that, when determining the meaning of "security" as used in the Acts, "form should be disregarded for substance and the emphasis should be on *economic reality*."<sup>70</sup> In *Golden*, although the form of the transaction was a sale

---

<sup>67</sup> 678 F.2d at 1142. Judge Winter reasoned that if the sale-of-business doctrine were valid, it would apply to *Golden*. *Id.* Significantly, *Golden* has been deemed an especially apposite case for application of the sale-of-business doctrine because the transaction was structured as a stock sale to avoid the nonassignment clause in the defendant's lease, the plaintiffs intended to assume complete control over the ticket brokerage business, and there was no serious question as to the plaintiffs' lack of reliance upon the entrepreneurial efforts of the defendant. Seldin, *supra* note 6, at 655-56. In light of the appropriateness of *Golden* for application of the sale-of-business doctrine, it is suggested that the court's rigid literalist approach stemmed from its fear that in future cases, there would be uncertain applications of the sale-of-business doctrine.

<sup>68</sup> See 678 F.2d at 1142-43. The court noted that the sale-of-business doctrine treats stock as a security in some instances and not in others, and that prior cases have focused upon the nature of the instrument, rather than the specific transactional context. *Id.* It has been argued that because the sale-of-business doctrine stresses the intent of the parties to the transaction, shares of stock may be "securities" for purposes of one party but not for another. Seldin, *supra* note 6, at 681. This anomaly is rectified when a "finer-grained" approach is taken to each transaction, viewing the situation as the transfer of distinct shares of stock in different but related transactions. *Id.* at 681 n.107.

<sup>69</sup> See 421 U.S. at 848. The Supreme Court recently has reiterated its position that substance governs form in securities cases by closely scrutinizing transactions that involve unusual instruments and restricting the scope of the federal securities laws. See, e.g., *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (SEC is required to establish scienter in rule 10b-5 actions); *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) (duty to disclose under section 10(b) of the '34 Act "does not arise from mere possession of nonpublic market information"); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 249-50 (1976) (purchaser of convertible debentures is liable as beneficial owner for profiteering from insider information in subsequent sale of stock only if he was such an owner prior to the purchase); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (private damages action under section 10(b) and rule 10b-5 must allege scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (private damages action under rule 10b-5 is confined to actual purchasers or sellers of securities). See generally Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892-900 (1977) (section 10(b) and rule 10b-5 litigation); Whitaker & Rotch, *The Supreme Court and the Counterrevolution in Securities Regulation*, 30 ALA. L. REV. 335, 345-76 (1979) (discussion of *Blue Chip Stamps* and *Hochfelder*).

<sup>70</sup> *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (emphasis added). There are at least three, and possibly four, different versions of the "economic reality" test. *Schneider, supra*

of stock in a ticket brokerage business, its substance was the sale of a business for the purpose of direct control and management by the purchasers. Such a transaction, unlike the typical shareholder investment in a large corporation managed by financiers, was not envisioned by Congress when it drafted the federal securities laws.<sup>71</sup> Moreover, even conceding that the shares transferred in *Golden* carried the common characteristics of stock, such as the right to receive dividends and voting rights, the purchasers, unlike the ordinary investor, acquired absolute control over these traits.<sup>72</sup> Thus, they seemingly could confer dividends upon themselves at

---

note 53, at 984-85. The "commercial investment dichotomy," apparently followed in the Third, Fifth, Seventh, Tenth and Eleventh Circuits, places emphasis upon the third component of the *Howey* formula, that is, "profits to come solely from the efforts of others." SEC v. W.J. *Howey* Co., 328 U.S. 293, 301 (1946). When the purchaser's expectations of profit come from his own efforts, the transaction is a commercial venture, not an investment, and the federal securities laws do not apply. See, e.g., *King v. Winkler*, 673 F.2d 342, 344-45 (11th Cir. 1982); *United Am. Bank v. Gunter*, 620 F.2d 1108, 1118-19 (5th Cir. 1980); *McGovern Plaza Joint Venture v. First of Denver Mortgage Investors*, 562 F.2d 645, 647 (10th Cir. 1977); *C.N.S. Enters., Inc. v. G. & G. Enters., Inc.*, 508 F.2d 1354, 1360-63 (7th Cir.), cert. denied, 423 U.S. 825 (1975); *Lino v. City Investing Co.*, 487 F.2d 689, 694-95 (3d Cir. 1973). The "risk capital" test, which has been applied in the Sixth and Ninth Circuits, focuses upon six criteria to determine whether the purchaser's investment represents "risk capital" or simply a commercial loan. These factors are: (1) length of investment period; (2) collateral; (3) form of obligation; (4) circumstances of issuance; (5) relationship between amount borrowed and size of borrower's business; and (6) intended use of the funds." See *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1182 (6th Cir.), cert. denied, 102 S. Ct. 972 (1981); see *AMFAC Mortgage Corp. v. Arizona Mall of Tempe, Inc.*, 583 F.2d 426, 432 (9th Cir. 1978). The "literal approach," followed in the Second Circuit and the United States District Court for the District of Columbia, stipulates that the federal securities laws apply when the instrument, on its face, is included expressly in the statutory definition of a security in the Acts. See *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662, 663 (2d Cir. 1971); *SEC v. Diversified Indus. Inc.*, 465 F. Supp. 104, 110 (D.D.C. 1979). The "strong family resemblance test," also followed in the Second Circuit, was established in *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976), when the court concluded that the federal securities laws did not apply to the note in question because it did not bear a strong family resemblance to (1) a "note delivered in consumer financing"; (2) a "note secured by a mortgage on a home"; (3) a "short-term note secured by a lien on a small business or some of its assets"; (4) a "note evidencing a 'character' loan to a bank or to a bank customer"; (5) "short-term notes secured by an assignment of accounts receivable"; or (6) "a note which simply formalizes an open-account debt incurred in the ordinary course of business." *Id.*; see *Banco Nacional de Costa Rica v. Bremer Holdings Corp.*, 492 F. Supp. 364, 368 (S.D.N.Y. 1980); *Altman v. Knight*, 431 F. Supp. 309, 312 (S.D.N.Y. 1977). By applying the foregoing criteria to determine whether a note is a security, the Second Circuit seemingly has posited that any note containing such qualities is within the literal meaning of the term "note" as used in the federal securities laws. See *Golden*, 678 F.2d at 1144 ("all instruments with characteristics agreed upon in the commercial world" to be included within the Acts' definition of a "security").

<sup>71</sup> See *supra* note 40.

<sup>72</sup> See *Seldin*, *supra* note 6, at 655.



will and vote all the stock as they pleased. In this respect, it is apparent that the shares of stock in *Golden* and in typical sale of business cases are unlike ordinary corporate stock.<sup>73</sup>

It also is submitted that, in attempting to interpret Supreme Court precedent in the securities field, the Second Circuit misconstrued *Marine Bank v. Weaver*<sup>74</sup> and failed to consider adequately *International Brotherhood of Teamsters v. Daniel*.<sup>75</sup> The *Golden* court observed that *Marine Bank* "lend[s] support to the view that conventional stock is a security whether or not the underlying transaction involves a sale of business."<sup>76</sup> It is arguable, however, that *Marine Bank* mandates application of the *Howey* test to stock transactions involving the sale of a business, notwithstanding the fact that *Howey* dealt with a purported investment contract. In *Marine Bank*, Chief Justice Burger twice referred to the caveat in the Acts, "unless the context otherwise requires,"<sup>77</sup> and observed that "Congress, in enacting the securities laws, did not intend to

---

<sup>73</sup> See Thompson, *supra* note 47, at 248. Professor Thompson emphasizes that, in determining whether the protection of the Acts should be extended to the purchaser, the focus should be upon whether the underlying transaction, not the instrument itself, embodies some of the significant characteristics typically associated with the named instrument. *Id.*; see Seldin, *supra* note 6, at 668. In *Golden*, neither the underlying transaction, which was intended as the sale of a business and not an investment scheme, nor the instruments transferred, which gave the purchasers total control over voting rights and the distribution of dividends, embodied the significant characteristics of ordinary corporate stock. Thus, the purchasers could not reasonably have relied upon the protection of the federal securities laws. See *supra* note 47.

<sup>74</sup> 102 S. Ct. 1220 (1982). In *Marine Bank*, the plaintiffs pledged a certificate of deposit with the issuing bank in order to secure a loan to a corporation. 102 S. Ct. at 1222. In consideration of the collateral, the corporation then agreed to provide certain benefits to the plaintiff, including a portion of any profits. *Id.* The Court held that the certificate of deposit was not a security because of the fixed rate of interest, virtual guarantee of full payment, and abundant protection under the federal banking laws. *Id.* at 1224-25. The separate agreement between the plaintiffs and the corporation was held not to be a security because it did not fall within "the ordinary concept of a security," did not have equivalent values to most persons, could not be traded publicly, and, significantly, afforded the plaintiffs a measure of control over the business of the corporation. *Id.* at 1225 (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)).

<sup>75</sup> 439 U.S. 551 (1979). For a discussion of the *Daniel* decision, see Bowers, *Daniel Thrown to the Lions: An Analysis of International Brotherhood of Teamsters v. Daniel*, 18 AM. BUS. L.J. 39 (1980); Note, *Securities Law: The Exclusion of Noncontributory, Compulsory Pension Plans—International Brotherhood of Teamsters v. Daniel*, 5 U. DAYTON L. REV. 191 (1980); Comment, *Securities Law—Applicability of the Securities Acts to Noncontributory, Compulsory Pension Plans—International Brotherhood of Teamsters v. Daniel*, 14 SUFFOLK U.L. REV. 159 (1980).

<sup>76</sup> 678 F.2d at 1143.

<sup>77</sup> 102 S. Ct. at 1223, 1225.

provide a broad federal remedy for all fraud."<sup>78</sup> Indeed, *Marine Bank* appears to have refined the *Howey* formula<sup>79</sup> by additionally requiring that, in order for the securities laws to apply, there be a showing that: (1) offers were made to several potential investors and the interest was not offered appurtenant to a private transaction; (2) the instruments in question have equivalent values to the general public and could be traded publicly; and, (3) the particular instrument contains no material features either unique to the plaintiff or generally uncharacteristic of a security.<sup>80</sup> Seemingly, the sale of the ticket brokerage business in *Golden* did not satisfy this refined *Howey* standard because offers were not made to a number of potential investors and the shares of stock were offered as part of a private transaction.<sup>81</sup>

In *Daniel*, the Supreme Court reiterated that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security."<sup>82</sup> The *Daniel* Court held that the Acts did not apply to a noncontributory, compulsory pension plan.<sup>83</sup> Although enunciated in the context of a purported investment contract, the Court observed, the test nonetheless is to be applied to conventional stock in light of "the substance — the economic realities of the transaction — rather than the names that may have been employed by the parties."<sup>84</sup> The Supreme Court also concluded that, in light of the Employee Retirement Income Security Act of 1974,<sup>85</sup> an extension of the securities acts to the pension plan in question would serve no general purpose.<sup>86</sup>

<sup>78</sup> *Id.* at 1223 (citing *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252, 1253 (9th Cir. 1976)); *Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1114 (5th Cir. 1974)).

<sup>79</sup> See Pitt, 'Weaver' Could Invite New Generation of Litigation, *Legal Times Wash.*, Mar. 15, 1982, at 18.

<sup>80</sup> 102 S. Ct. at 1225.

<sup>81</sup> See 678 F.2d at 1140.

<sup>82</sup> 439 U.S. at 558 n.11 (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975)).

<sup>83</sup> 439 U.S. at 570; see *Salazar v. Sandia Corp.*, 656 F.2d 578, 582 (10th Cir. 1981); *Michota v. Anheuser-Busch, Inc.*, 526 F. Supp. 299, 317-18 (D.N.J. 1980), *aff'd sub nom. Adams v. N.J. Brewery Employees' Pension Trust Fund*, 670 F.2d 387, 401 (3d Cir. 1982); *Tanuggi v. Grolier, Inc.*, 471 F. Supp. 1209, 1212-15 (S.D.N.Y. 1979).

<sup>84</sup> 439 U.S. at 558 (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851-52 (1975)).

<sup>85</sup> 29 U.S.C. §§ 1001-1381 (1976 & Supp. IV 1980). The Act vests the Department of Labor with power to oversee private pension plans. *Id.* §§ 1131-1135. See generally Comment, *The Employee Retirement Income Security Act of 1974: Policies and Problems*, 26 SYRACUSE L. REV. 539, 663-66 (1975).

<sup>86</sup> 439 U.S. at 569-70.

Taken together, *Marine Bank* and *Daniel* reflect the Supreme Court's recent tendency to restrict the scope of the federal securities laws,<sup>87</sup> contrary to the *Golden* result. In both cases, the Court emphasized that protection was afforded by sources other than the federal securities laws<sup>88</sup> and, therefore, that the Acts' protection was not necessary.<sup>89</sup> Similarly, the parties in *Golden* were protected effectively by state securities regulations.<sup>90</sup>

#### INTENT TO MANAGE: THE NINTH CIRCUIT APPROACH

The greater part of the *Golden* court's rationale for rejecting the sale of business doctrine centered around its fear that any inquiry into a purchaser's intent is too subjective to function as an evidentiary standard. The Second Circuit warned that "[i]f intent to manage is relevant, adoption of the doctrine will lead to countless issues of mixed fact and law."<sup>91</sup> Specifically, the court questioned whether part-time managers and controlling shareholders who occasionally make significant management decisions would be held to have "an intent to manage," and also noted the uncertain status of new investors who are employed by the business in a vague capacity, or who buy shares of stock with no intent to manage but later are required to make major decisions for the business because of unforeseen circumstances.<sup>92</sup> In *SEC v. Glenn W. Turner Enterprises, Inc.*,<sup>93</sup> the Ninth Circuit adopted a versatile test to

---

<sup>87</sup> See *supra* note 67.

<sup>88</sup> See *supra* note 74; text accompanying notes 85-86.

<sup>89</sup> See *supra* notes 59-62 and accompanying text.

<sup>90</sup> Section 352 of the New York General Business Law empowers the Attorney General of the State of New York to investigate instances where "any person . . . corporation . . . or any agent or employee thereof . . . [has] employed . . . any device, scheme or artifice to defraud" in sales of securities. N.Y. GEN. BUS. LAW § 352(1) (McKinney 1968). For judicial construction of the statute, see Charles H. Greenthal & Co., Inc. v. Lefkowitz, 32 N.Y.2d 457, 462-63, 299 N.E.2d 657, 658-59, 346 N.Y.S.2d 234, 236-37 (1973); Gardner v. Lefkowitz, 97 Misc. 2d 806, 811-13, 412 N.Y.S.2d 740, 745-46 (Sup. Ct. N.Y. County 1978).

<sup>91</sup> 678 F.2d at 1145-46.

<sup>92</sup> *Id.* One commentator has suggested that a factor which may bear upon the question of intent to manage is whether the purchaser has previous managerial experience in the type of business being purchased, or whether he or she possesses the "requisite general knowledge, sophistication or managerial skill to take responsibility." Seldin, *supra* note 6, at 679. All of these factors apparently were present in *Golden*. See 678 F.2d at 1147 (Lumbard, J., dissenting).

<sup>93</sup> 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973). *Turner Enterprises* involved a Florida corporation that sold public contracts characterized as self-improvement courses. *Id.* at 477-78. The corporation, a subsidiary of Glenn W. Turner Enterprises, Inc., conducted a "pyramid" operation whereby some of the purchasers of the self-improvement

determine whether an instrument is an investment contract.<sup>94</sup> It is submitted that the same test may be used to ascertain whether a shareholder qualifies for the protection afforded by the federal securities laws in the problematic situations mentioned by the *Golden* court.

Under the *Turner Enterprises* standard, 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."<sup>95</sup> This test is a modification of the third component of the *Howey* "economic reality" test, which assesses the expectation of profits "solely from the efforts of the promoter or a third party."<sup>96</sup> Under the Ninth Circuit's approach, a purchaser's reliance upon the "essential managerial efforts of others" establishes an investment contract within

---

courses became "independent sales trainees," enabling them to sell the courses to others and receive a commission. *Id.* at 478. Even though the purchaser invested some of his own efforts in the scheme, the court held that the contracts were securities because "the requirement that profits come 'solely' from the efforts of others would, in circumstances such as these, lead to unrealistic results if applied dogmatically, and that a more flexible approach is appropriate." *Id.* at 483; see *Smith v. Gross*, 604 F.2d 639, 642 (9th Cir. 1979); *American Grain Ass'n v. Canfield, Burch & Mancuso*, 530 F. Supp. 1339, 1345 (W.D. La. 1982); *Westlake v. Abrams*, 504 F. Supp. 337, 342-43 (N.D. Ga. 1980). See generally Comment, *What is a Security?* *Howey, Turner Enterprises, and Franchise Agreements*, 22 KAN. L. REV. 55, 70-78 (1973).

<sup>94</sup> The Fifth, Seventh and Tenth Circuits also follow the Ninth Circuit "managerial efforts" test. See *Goodman v. Epstein*, 582 F.2d 388, 408 n.59 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877, 879 (10th Cir. 1978); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974). For variations of the *Howey* formula in state courts, see *Burke v. State*, 385 So. 2d 648, 651-52 (Ala. 1980); *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815-16, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961); *State v. Hawaii Market Center, Inc.*, 52 Hawaii 642, 648-49, 485 P.2d 105, 108-09 (1971). See generally *Carney & Fraser, Defining a "Security": Georgia's Struggle With the "Risk Capital" Test*, 30 EMORY L.J. 73, 80-96, 102-08 (1981).

<sup>95</sup> 474 F.2d at 482. The managerial efforts issue has been important in determining whether a "security" exists in partnership transactions. See, e.g., *Vincent v. Moench*, 473 F.2d 430, 436 (10th Cir. 1973); *Murphey v. Hillwood Villa Assocs.*, 411 F. Supp. 287, 290 (S.D.N.Y. 1976); *Hirsch v. duPont*, 396 F. Supp. 1214, 1223-24 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977). See generally *Long, Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581, 596-615 (1972) (discussion of various partnership agreements as securities). In *Kane v. Fischbach*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,608, at 92,988-89 (E.D.N.Y. Mar. 31, 1982), a sale of less than 100% of the shares in an automobile rebuilding business to the controlling partners of a partnership was held not to be within the ambit of the federal securities laws. *Id.* The seller was a controlling partner and was retained by the partnership as executive vice president. *Id.* at 92,985-86. The court held that the transfer was "nothing more than the sale of a small business" by the seller because the purchasers had control over both the business and the partnership. *Id.* at 92,989.

<sup>96</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).

the meaning of the Acts. The same test, but with an inversion of the significance of the results, could be utilized to evaluate transactions involving shares of stock where the purchaser's role in the business is vague or ambiguous.<sup>97</sup> If the purchaser is found to be supplying the "undeniably significant" managerial efforts, an intent to manage, and thus a sale of business is established, thereby precluding application of the federal securities laws.

### CONCLUSION

Congress, in enacting the federal securities laws, intended to protect those investors who possess a mere "indicia of ownership," with the power to control the business remaining in the hands of others. A close reading of the legislative history reveals that there was no intent to protect purchasers who obtain 100 percent of the shares of a business and exercise control over it. In addition, this class of purchasers has no reasonable basis to rely upon the protection of the '33 and '34 Acts.

The limited scope of the securities laws was confirmed by the Supreme Court in *Forman* and *Marine Bank*, which indicate that an inquiry into the "economic reality" of the transaction is necessary, even where the instrument in question possesses the usual characteristics of corporate stock. The *Golden* decision, by foreclosing an examination of the economic reality of the transaction if the instrument carries the common characteristics of corporate stock, expands the intended protection of the Acts and provides an overlap of remedies for the purchaser of a business. This result is clearly untenable in light of *Forman* and *Marine Bank*.

When an inquiry into the economic reality of the transaction reveals ambiguity or vagueness concerning the purchaser's intent to manage the business, the "managerial efforts" test created by the Ninth Circuit can be employed to determine whether the purchaser actually controls the business. Thus, in rejecting the sale of business doctrine, the Second Circuit has discarded a pragmatic and discerning approach that presents no undue difficulties of application and properly limits the scope of the federal securities laws.

*Donald E. Miehls*

---

<sup>97</sup> Cf. *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 467 n.5 (7th Cir.), cert. denied, 102 S. Ct. 136 (1981) (sale of business doctrine not applicable because plaintiff-seller was an employee who regarded his equity interest in the business as an investment).