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ACQUISITION OF BUSINESSES THROUGH PURCHASE OF CORPORATE STOCK: AN ARGUMENT FOR EXCLUSION FROM FEDERAL SECURITIES REGULATION

CHRISTINE L. McANENY

I. INTRODUCTION

Until recently, it has been assumed that the sale of an incorporated business by means of a transfer of stock would fall within the purview of the federal securities laws.¹ Since 1970, however, defendants charged with securities violations in federal courts have argued "no jurisdiction" for this type of transaction.² Arguing by analogy from two Supreme Court decisions,³ and from decisions in promissory note cases⁴ and partnership cases,⁵ the contention has been that, although the term "stock" is included within the statutory definitions, corporate stock acquired incident to the purchase of a business is not a "security" within the meaning of the Securities Act of 1933 (the 1933 Act)⁶ and the Securities Exchange Act of 1934 (the 1934 Act).⁷

1. See, e.g., *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961), where defendant selling 100% of corporate stock contested federal jurisdiction, contending that the federal securities laws exclude private transactions taking place independently of the national exchanges. The defendant did not contend, as do the defendants in the principal cases of this comment, that stock is not a security when the transaction involves the sale of a business.

2. Although the Securities Act of 1933 provides for concurrent state jurisdiction, 15 U.S.C. § 77r (1976), thus far only federal courts have examined the question addressed in this comment.

3. *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

4. See, e.g., *Emisco Indus., Inc. v. Pro's Inc.*, 543 F.2d 38 (7th Cir. 1976). See generally cases cited in Annot., 39 A.L.R. Fed. 357 (1978).

5. See, e.g., *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973).

6. 15 U.S.C. §§ 77a-77aa (1976). The term "security" is defined by the Securities Act of 1933 as follows:

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

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, 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 U.S.C. § 77b(1) (1976).

7. 15 U.S.C. §§ 78a-78kk (1976). The Securities Exchange Act of 1934 defines the term "security" as follows:

(a) When used in this chapter, unless the context otherwise requires—

Typically, these stock transaction cases involve the sale of a small business, *i.e.*, a close corporation.⁸ Since this is a commonplace occurrence, determining whether a security is involved has become significant not only to the securities specialist, but also to any lawyer whose client wishes to purchase or sell an incorporated business. In the event of alleged fraud in the sale, a federal forum is frequently more advantageous for plaintiffs than a state forum.⁹ In addition, securities fraud provisions are more advantageous for plaintiffs because they are broader in scope than common law rem-

. . . .

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1976).

The definition of "security" under the 1933 Act and the 1934 Act is similar and the Supreme Court has treated the two definitions synonymously. See *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975). For purposes of this comment the two will be treated as identical. Note also that the American Law Institute's proposed consolidated Federal Securities Code does not substantially change the definition of a security:

Sec. 299.53. [Security.] (a) [General.] "Security" means a bond, debenture, note, evidence of indebtedness, share in a company (whether or not transferable or denominated "stock"), . . . investment contract, . . . or, in general, an interest or instrument commonly considered to be a "security,"

(b) [Exclusions.] Notwithstanding section 299.53(a), "security" does not include . . . a note or evidence of indebtedness issued in a primarily mercantile or consumer, rather than investment, transaction not involving a distribution

ALI FED. SEC. CODE § 299.53(a), (b) (March 1978 Draft).

8. They may also involve the sale of a wholly owned subsidiary of a large corporation. See *Occidental Life Ins. Co. v. Pat Ryan & Assocs.*, 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974).

9. The Securities Exchange Act of 1934 provides for exclusive federal jurisdiction and has broad venue and nationwide service of process provisions. 15 U.S.C. § 78aa (1976). Furthermore, attorneys' fees may be recovered by the successful litigant. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 389-97 (1970), where the Supreme Court stated that an award of attorneys' costs under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1976), was allowable, although not expressly authorized by the statute. *But see Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 241-43 (1975), where the circuit court, using a "private attorney general" theory, awarded attorneys' fees in a suit brought under the Mineral Leasing Act, 30 U.S.C. § 185 (1976). The Supreme Court reversed, reasoning that, unless expressly authorized by statute, the general rule is that a successful party in federal litigation may not recover attorneys' fees. 421 U.S. at 260-71.

edies.¹⁰ Therefore, a participant in a simple, face-to-face business sale involving a stock transaction may well find himself in a federal court defending a fraud action.

Seven reported federal cases have considered whether a transfer of stock incident to the sale of a business falls within federal securities laws.¹¹ Only two appellate courts, however, have dealt with this issue. The Tenth Circuit has concluded that the sale of a business through a stock transfer is not a securities transaction,¹² while the Fourth Circuit has reached the opposite result.¹³

The premise of this comment is that stock transactions should not automatically be deemed to be securities under federal law. A distinction should be made between passive investors in corporate stock, and purchasers and sellers of corporate businesses who use stock as a means of transferring their interests. The federal securi-

10. Due to a liberal reading given by the courts, many actions are brought under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), which was promulgated under the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1976). See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (unlike common law fraud or deceit, reliance not a prerequisite to recovery under rule 10b-5); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978) (common law improper motive not required, rule 10b-5 requires only knowledge or recklessness); *Baretge v. Barnett*, 553 F.2d 290 (2d Cir. 1977) (privity between plaintiff and defendant not necessary under rule 10b-5); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965) (common law affirmative misrepresentation not required, under rule 10b-5 nondisclosure of material information is actionable); *SEC v. Penn Central Co.*, 450 F. Supp. 908 (E.D. Pa. 1978) (rule 10b-5 causation defined with reference to proximate cause, resulting in broad liability). See also *Campbell, Elements of Recovery Under Rule 10b-5: Scien-ter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 S.C. L. REV. 653 (1975). For a discussion of common law difficulties, see Note, *Franchising as a Security*, 33 OHIO ST. L.J. 718, 720 (1972); Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1123-26 (1950). But see *Newton, The Limits of Liability: Recent Judicial Restrictions on Rule 10b-5*, 6 FLA. ST. U.L. REV. 63 (1978) suggesting that recent Supreme Court decisions have narrowed the scope of federal securities laws.

11. *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 100 S. Ct. 142 (1979); *Chandler v. Kew, Inc.*, [1979] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. April 19, 1977); *Occidental Life Ins. Co. v. Pat Ryan & Assocs.* 496 F.2d 1255 (4th Cir.), cert. denied, 419 U.S. 1023 (1974); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bula v. Mansfield*, [1979] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539 (N.D. Ill. 1970). The *Federal Securities Law Reporter* recently published another district court opinion holding that the transfer of stock incident to the sale of a business was not a securities transaction. In *Druker v. Turner*, [1980] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979) the court relied on *Chandler v. Kew* and *Bula v. Mansfield* in so holding.

12. *Chandler v. Kew, Inc.*, [1979] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. April 19, 1977).

13. *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 100 S. Ct. 142 (1979); *Occidental Life Ins. Co. v. Pat Ryan & Assocs.*, 496 F.2d 1255 (4th Cir.), cert. denied, 419 U.S. 1023 (1974).

ties laws should be construed to include within their purview only stock purchased or sold by passive investors who rely on the expertise of others for their profits. Initially, the two decisions excluding stock transfers incident to the sale of businesses from federal securities protections will be examined. Next, the cases holding that these transactions are protected by federal laws will be analyzed. Finally, an argument will be presented for the application of the three-part investment contract formula to stock transfers. Application of this formula would result in a functional rather than a formalistic determination of when stock constitutes a security. Passive investors would be protected by federal securities laws, while transactions involving the simple acquisition of a business would be relegated to state forums.

II. STOCK IS NOT NECESSARILY A "SECURITY"

In *Chandler v. Kew, Inc.*,¹⁴ the Tenth Circuit Court of Appeals upheld a district court ruling that the acquisition of a liquor store through the purchase of 100% of the business's stock was not a securities transaction within the definitions of the 1933 and 1934 Acts. In a brief, unpublished opinion the court cited *United Housing Foundation, Inc. v. Forman*,¹⁵ a Supreme Court case, as the basis for its result. The Tenth Circuit noted that *Forman* had rejected a suggestion that all instruments called stock were securities simply because they literally fell within the statutory definitions.¹⁶ Relying on language in *Forman* to the effect that the application of the securities laws must turn on the economic realities of a transaction,¹⁷ the court ruled that the plaintiff's motive was to buy a liquor store. The transfer of stock, the court concluded, was simply an indicium of ownership incident to the sale of the store.¹⁸

One month later, *Chandler* served as controlling precedent for the Colorado district court in *Bula v. Mansfield*.¹⁹ That case in-

14. [1979] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. April 19, 1977). Note, ten years earlier, in *Chiodo v. General Waterworks Corp.*, 380 F.2d 860, 863-64 (10th Cir.), cert. denied, 389 U.S. 1004 (1967), the Tenth Circuit indicated in dictum that the transfer of stock incident to the sale of a business should not be included within the scope of federal securities laws.

15. 421 U.S. 837 (1975).

16. [1979] FED. SEC. L. REP. (CCH) ¶ 96,966, at 96,054.

17. The *Forman* Court stated, "Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." 421 U.S. at 849.

18. [1979] FED. SEC. L. REP. (CCH) ¶ 96,966, at 96,054.

19. [1979] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977).

volved an attempted purchase of a restaurant through acquisition of all the stock of the parent company. Plaintiffs alleged that the fraud provisions of the 1934 Act were violated during the attempted sale. The district court determined that federal jurisdiction did not exist because the economic reality was that the plaintiffs had contracted to purchase a restaurant.²⁰ As in *Chandler*, the stock constituted only an indicium of ownership of the restaurant.²¹

The *Chandler* opinion was based substantially on the Supreme Court's *Forman* decision. It should be noted, however, that the facts in *Chandler* and the facts in *Forman* differ. Additionally, *Forman* contains language which can be construed to support both sides of the security-nonsecurity argument.

The Supreme Court in *Forman* was presented with the question of whether shares of "stock" in a state-subsidized, nonprofit housing cooperative were securities.²² In order to acquire an apartment, a purchaser bought shares of stock in the cooperative, the number of shares purchased being dependent on the number of rooms desired. A purchaser wishing to terminate his occupancy was required to offer the shares back to the cooperative at the original price.²³

The Supreme Court conducted a two-step analysis to determine whether the stock in *Forman* was a security within the purview of the federal acts. First, the Court rejected the notion that interests designated as stock necessarily fall within the statutory definitions of a security.²⁴ The Court stressed that substance rather than form must determine the meaning of a term like "security," and that emphasis should therefore be placed upon the economic realities of the transaction.²⁵ The Court also noted that the shares in question did not possess features typically associated with stock. They were not negotiable, could not be pledged, conferred no voting rights, paid no dividends, and could not increase in value.²⁶

After determining that the shares were not stock in the traditional sense, the Court turned to the question of whether the shares met the investment contract formula set forth twenty-nine

20. *Id.* at 96,052.

21. *Id.*

22. 421 U.S. at 840.

23. *Id.* at 842.

24. *Id.* at 848.

25. *Id.* (citing *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

26. *Id.* at 851.

years before in *SEC v. W.J. Howey Co.*²⁷ "Investment contracts" are included in the list of instruments designated as securities by the federal definitions.²⁸ In *Howey*, the Supreme Court applied a three-part formula to determine whether the instruments in question were investment contracts and therefore "securities" under the federal acts. For an instrument to be classified an investment contract *Howey* requires (1) an investment of money, (2) a common enterprise, and (3) an expectation of profits solely from the efforts of others.²⁹ While the *Howey* Court applied the formula to investment contracts, the *Forman* Court indicated that the formula was equally applicable to determining whether other instruments were securities.³⁰ Applying the investment contract analysis to the cooperative's stock, the *Forman* Court found that there was no expectation of profits.³¹ The purchasers' motivation was to acquire an apartment to live in, and not to reap a financial return on an investment. Therefore, the *Forman* Court concluded that the shares of stock were not securities.³²

Forman demonstrates that, although "stock" is included in the statutory list of securities instruments,³³ stock may not always be a "security" for federal purposes. As noted before, however, the facts

27. 328 U.S. 293 (1946).

28. See notes 6, 7 *supra*.

29. 328 U.S. at 298-99. The Howey Company was engaged in selling narrow strips of land in a citrus grove. The company told purchasers that it was not feasible to invest in the grove without making service arrangements, and offered a service contract for the cultivation and marketing of the fruit grown on the land. *Id.* at 295. The issue was whether the 1933 Act applied to the Howey Company's operations. *Id.* at 297. The sale of land in conjunction with a service contract is not a transaction which is usually characterized as a security. The Court, however, found that such transactions clearly involved investment contracts because "something more" than a transfer of rights in land was involved. *Id.* at 299. The purchasers had no interest in personally occupying or developing the land, but were solely interested in making a profit. In actuality, management of the enterprise by the sellers was part of the value of the investment. *Id.* at 300. Accordingly, the elements of an investment contract were present since the investors provided the capital and shared in the profits and the promoters controlled the enterprise. Thus, the 1933 Act was applicable. *Id.*

30. The Court stated that:

We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.'" In either case, the basic test for distinguishing the transaction from other commercial dealings is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. . . ." This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security.

421 U.S. at 851-52 (quoting *Howey*, 328 U.S. at 301).

31. *Id.* at 857.

32. *Id.* at 858.

33. See notes 6, 7 *supra*.

in *Forman* are distinguishable from the facts before the *Chandler* court. In *Forman*, plaintiffs were buying a place to live; in *Chandler*, plaintiffs were buying an incorporated business. In *Forman*, the Court first determined that what was called stock lacked some traditional investment characteristics of stock. The *Forman* Court then went on to make a determination based on economic realities that the shares were not securities. In *Chandler*, while the court correctly focused on the economic realities of the transaction, the stock itself was not examined to determine whether traditional characteristics were present.

Courts which have included the acquisition of businesses involving stock transfers within the purview of federal protections distinguish *Forman* on the basis that the stock in *Forman* did not possess traditional characteristics.³⁴ These courts have reasoned that when stock transferred incident to the sale of businesses possesses traditional characteristics, the economic realities of the transaction need not be examined. Stock possessing traditional characteristics, according to these courts, falls within the definition of a "security" without the necessity of meeting the further "investment contract" requirement of *Howey*. As part IV of this comment will demonstrate, labeling an instrument a security must be based upon an investor-oriented analysis of the economic realities underlying the transaction. The realistic approach, rather than a superficial determination of whether traditional characteristics are present, is the major lesson of the *Forman* decision. Regrettably, the *Chandler* court's short opinion is silent concerning the issue of whether the presence or absence of traditional characteristics is significant. The opinion is drawn in such conclusional terms that it provides small comfort to defendants faced with an array of cases holding that stock transactions involving the purchase of a business are always securities.

III. STOCK IS A "SECURITY"

Subsequent to *Bula*, another judge in the District of Colorado scrutinized the *Forman* decision more closely. In *Titsch Printing, Inc. v. Hastings*,³⁵ plaintiffs purchased all the stock of two family-operated businesses. Defendants moved to dismiss the fraud action

34. See *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 100 S. Ct. 142 (1979); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

35. 456 F. Supp. 445 (D. Colo. 1978).

brought under the 1934 Act, contending that the stock was merely an indicium of ownership and not a security.³⁶ Unlike the *Bula* court, the *Titsch* court did not summarily rule for the defendants based on *Chandler*. Rather, the *Titsch* court found that the stock exhibited the traditional characteristics listed by *Forman*, i.e., the stock was negotiable, carried the right to receive dividends, conferred voting rights, could be pledged, and could increase in value.³⁷ On that basis the court purported to distinguish *Chandler* by stating, "The stock in this case is not a mere 'indicia of ownership' as found in *Chandler v. Kew*, . . . but rather the substance of the purchase itself."³⁸

The *Titsch* defendants alternatively contended that the investment contract formula of *Forman* must be applied to determine whether any stock transaction fell within the securities laws.³⁹ The *Titsch* court agreed that there was language in the *Forman* decision to support the defendants' argument,⁴⁰ but pointed out that the *Forman* Court had first examined the stock for traditional characteristics.⁴¹ The investment contract formula was not applied in *Forman* until *after* the Court determined that the stock in question had no traditional characteristics. The *Titsch* court postulated that the formula was developed because there was no commonly accepted meaning of "investment contract."⁴² The court reasoned that there was no need to use an investment contract analysis because "stock" has an accepted meaning, and because persons buying stock are entitled to assume they may rely on the protection of the federal securities laws. Applying the traditional characteristics test, the *Titsch* court determined that the acquisition of the corporate business by purchase of 100% of its stock was a federally governed securities transaction.⁴³

One year prior to the *Forman* decision, the question of whether the sale of a business through a stock transfer is a securities transaction for federal purposes was presented to the Fourth Circuit Court of Appeals in *Occidental Life Insurance Co. v. Pat Ryan &*

36. *Id.* at 446.

37. *Id.* at 448.

38. *Id.* (citations omitted). No other distinction was made, although the facts of *Chandler* and *Titsch* could hardly be closer; both involved the sale of businesses with 100% stock transfers.

39. *Id.*

40. See *Forman*, 421 U.S. at 851-52, quoted at note 30 *supra*.

41. 456 F. Supp. at 448-49.

42. *Id.* at 449.

43. *Id.*

Associates.⁴⁴ Occidental Life Insurance Company of North Carolina (Occidental) agreed to sell the outstanding stock of a subsidiary, Virginia Surety Company, Inc. (Surety), to Pat Ryan and Associates, Inc. (Associates).⁴⁵ Surety was engaged in insuring long-haul trucking activities, and Associates wished to purchase Surety in order to use that company's state licenses to expand into other states. The agreement contemplated that Surety would be stripped of most of its assets and all of its liabilities prior to the sale. Its only assets at the time of sale would be its charter, state licenses, and bonds deposited with state insurance commissioners.⁴⁶ After the closing, both parties became dissatisfied with each other's conduct. Occidental sued for breach of contract in state court, but Associates removed to federal court alleging, among other things, violation of the 1934 Act.⁴⁷

Occidental claimed that the sale of stock was merely incidental to the purchase of business assets. The purpose of the 1934 Act, Occidental maintained, is to protect investors. Because the sale of business assets is commercial in character, and not of an investment nature, the transaction should solely be a matter for state regulation. Therefore, although literally covered by the federal securities definitions, this sale of stock by Occidental should not be deemed a securities transaction.⁴⁸ Occidental proposed that the investment contract analysis be uniformly applied to all instruments used in sale transactions to determine whether a securities transaction had occurred.⁴⁹

The Fourth Circuit, however, rejected Occidental's proposal for a

44. 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974). One other case, *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539 (N.D. Ill. 1970), considered whether the use of a stock transfer to effectuate the sale of a business is within the purview of federal securities laws. The defendants relied on *Chiodo v. General Waterworks Corp.*, 380 F.2d 860 (10th Cir.), *cert. denied*, 389 U.S. 1004 (1967), the Tenth Circuit predecessor of *Chandler*. The *Bailey* court rejected *Chiodo* and held that the transaction was a sale of securities within the purview of federal securities laws. 320 F. Supp. at 543-44.

45. Whether the sale of a business involves a securities transaction is a question which usually arises in cases involving close corporations. *Occidental*, however, involved the purchase and sale of a subsidiary corporation. A corporation may choose to buy another corporate business through purchase of its outstanding stock. Under the investment contract formula, the purchaser and the seller would not be relying on the efforts of others. Rather, as sole purchaser and sole seller, they would be in direct control of the subsidiary. Hence, under the formula, the sale of stock would not be a securities transaction, as between them.

46. 496 F.2d at 1259.

47. *Id.* at 1260.

48. *Id.* at 1261.

49. *Id.*

uniform analysis, finding that it ran counter to Supreme Court statements that instruments literally fitting within the securities definitions as a matter of law should be included within the federal protections.⁵⁰ Since Occidental chose to deal in stock, the federal securities laws were held applicable.⁵¹

In response to the argument that the sale of a business is a commercial transaction that is properly regulated by state law, the Fourth Circuit quoted Supreme Court language to the effect that the 1934 Act is not limited to protecting organized markets, but also extends to private transactions.⁵² In rejecting a public/private dichotomy, however, the Fourth Circuit set up a straw man. It is established law that the federal securities laws apply to private securities transactions.⁵³ The critical question before the court was not whether the transaction was public or private, but whether a security was involved in the transaction. If a security was not involved, then none of the securities provisions would apply regardless of whether the transaction was public or private. Occidental's claim that no securities transaction existed was based on the non-investment character of the transaction, not on its private nature.

The Fourth Circuit acknowledged that *Lino v. City Investing Co.*,⁵⁴ a promissory note case, provided support for Occidental's contention that a distinction should be made between purely commercial, noninvestment transactions and investments protected by federal securities laws.⁵⁵ In *Lino*, the plaintiff alleged that he was induced to purchase franchise licensing agreements by material misstatements made by the parent company in violation of the federal securities laws.⁵⁶ The federal laws were applicable, the plaintiff contended, because promissory notes, given as part of the consideration for the purchase, were securities within the Acts' definitions.⁵⁷ The *Lino* court determined that the notes in question were neither offered for sale to the public nor acquired by the defendant for investment purposes. They were simply part of the

50. *Id.* (citing *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967)).

51. *Id.* at 1263.

52. *Id.* at 1262 (citing *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971)).

53. *See, e.g.*, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971); *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960).

54. 487 F.2d 689 (3d Cir. 1973).

55. *Occidental*, 496 F.2d at 1262 n.3.

56. 487 F.2d at 690.

57. *Id.*

consideration given for the purchase of the franchise.⁵⁸ Rather than announcing a test for identifying a security in a transaction involving promissory notes, the court emphasized that the facts indicated the notes in question were commercial in character.⁵⁹ Hence, although "notes" are instruments designated as securities by the federal definitions,⁶⁰ the commercial character of the notes in *Lino* required the finding that the notes were not securities.⁶¹ Therefore, the transaction was governed by state law and the federal securities laws did not apply.

The Fourth Circuit concluded that *Lino* was inapplicable because the purchase of stock involved an investment and because Occidental could have offered Surety to any member of the public.⁶² The purchase was held to be an investment because Associates wanted to buy an enterprise with a good reputation in order to expand its business.⁶³ Of course, every sale of a business, with or without a stock transfer, involves a "public offering" and an "investment" in the sense that the Fourth Circuit used those terms. Nevertheless, the court expressed concern that large investors, as well as small investors, should be protected. A formula which requires disparate treatment based on whether a small interest or a controlling interest is purchased would, according to the court, be arbitrary and capricious.⁶⁴ The fact that the parties could have consummated their deal without the use of stock was irrelevant.⁶⁵

In summary, the *Occidental* ruling turned on two factors: (1) Supreme Court indications that stock may, as a matter of law, be securities; and (2) judicial concern that any standard applied to stock transfers distinguishing purely commercial transactions from transactions covered by securities laws would be capricious.

The Fourth Circuit was next presented with this troublesome issue in *Coffin v. Polishing Machines, Inc.*⁶⁶ The defendant, desiring

58. *Id.* at 694-95.

59. The facts were (1) personal promissory notes were given for the purchase of franchise licensing agreements, (2) there was no public offering, (3) the defrauded party was the issuer of the notes, (4) the defendant did not procure the notes for investment, and (5) the defendant was not soliciting venture capital. *Id.*

60. See notes 6, 7 *supra*.

61. 487 F.2d at 694. The court also indicated that an opposite holding would bring most retail credit transactions within the purview of federal securities regulations. *Id.* at 695.

62. 496 F.2d at 1262 n.3.

63. *Id.* at 1263.

64. *Id.*

65. "The plain fact is that they *did* choose to use the stock." *Id.* (emphasis in original).

66. 596 F.2d 1202 (4th Cir.), cert. denied, 100 S. Ct. 142 (1979), *rev'g Coffin v. Tricoli*, 470 F. Supp. 7 (E.D. Va. 1977).

to finance an expansion, encouraged the plaintiff to purchase stock in the defendant's company. The plaintiff agreed to purchase half of the outstanding shares and to serve as executive vice president of the company. After the sale had taken place, the plaintiff discovered that the company was insolvent. He subsequently brought an action to recover damages under the federal securities acts.⁶⁷ The district court determined that although stock was involved, the actual substance of the transaction was a purchase of a half-interest in a business.⁶⁸ The district court held that the investment contract analysis used in *Forman* was applicable to all alleged securities transactions.⁶⁹ The *Coffin* transaction failed the investment contract test because the plaintiff was not relying solely on the efforts of others for his profit, but had assumed a managerial function in the business. Consequently, the stock was not a security, and the court dismissed the case for lack of federal jurisdiction.⁷⁰

On appeal, the Fourth Circuit reversed, holding that *Forman* requires application of the investment contract analysis only when the stock does not meet the traditional characteristics test.⁷¹ Citing *Occidental*, the court stated it need not consider whether the outcome would be different had the parties used some other form (e.g., a partnership agreement) for their transaction.⁷² The court also noted that the sale of stock in this case was for the purpose of corporate expansion, "the very sort of transfer with which the federal securities laws are most concerned, 'the sale of securities to raise capital for profit-making purposes.'"⁷³

Whether shares of stock are securities was also at issue in *Bronstein v. Bronstein*.⁷⁴ Two brothers and their father each owned one-third of a real estate development corporation's outstanding shares. Both brothers were officers of the corporation, but the defendant brother handled the financial matters of the business while the plaintiff brother supervised the corporation's construction activities.⁷⁵ The plaintiff alleged that federal securities laws

67. 470 F. Supp. at 8.

68. *Id.* at 9.

69. *Id.* at 10. See *Forman*, 421 U.S. at 851-52, quoted at note 30 *supra*.

70. 470 F. Supp. at 11-12.

71. 596 F.2d at 1204.

72. *Id.*

73. *Id.* (quoting *Forman*, 421 U.S. 837, 849 (1975)).

74. 407 F. Supp. 925 (E.D. Pa. 1976).

75. *Id.* at 926. The court indicated that the plaintiff completely relied upon his brother, the defendant, for information regarding the value of the business' assets because of his

were violated when the defendant induced him to sell his stock without disclosing its true value.⁷⁶

The defendant relied on *Forman*, as well as on partnership and promissory note cases, to support his argument that the investment contract analysis should be applied to the transaction. Under that analysis, he contended, the stock transfer was not a security.⁷⁷

The district court distinguished *Forman* by quoting a passage where the *Forman* Court, in analyzing the cooperative's stock for traditional characteristics, 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.*⁷⁸

The *Bronstein* court noted that the corporation's stock possessed all of the traditional attributes of stock.⁷⁹ Hence, the cited *Forman* language was applicable. The court concluded that the plaintiff had a reasonable expectation that the federal securities laws would apply.⁸⁰ The court also stated that the investment contract analysis requires an inquiry into corporate and shareholder relationships. It observed that such extensive factual inquiry is inappropri-

inexperience with financial aspects of the business. In addition, the plaintiff was told by the defendant not to retain his own attorney because the defendant, "as a brother, was looking out for plaintiff's interests." *Id.*

76. *Id.* at 926-27. Note that in all of the previously mentioned cases the person claiming to be defrauded was the purchaser. In *Bronstein*, however, the seller claimed to be defrauded. The federal antifraud provisions apply to both purchaser and seller under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), and it appears that the investment contract analysis is equally applicable to both. For a seller the test would be whether the seller had merely a passive role in the enterprise or had exercised significant managerial efforts. For example, a minority shareholder in a close corporation would clearly meet the investment contract test and would be federally protected while a controlling shareholder might not be. In cases similar to *Bronstein*, courts must analyze the facts to determine the extent of the shareholder's relationship with the corporation. See generally *Emisco Indus., Inc. v. Pro's, Inc.*, 543 F.2d 38 (7th Cir. 1976) (both purchaser and seller contended that note given as partial consideration was a security).

77. 407 F. Supp. at 927.

78. *Id.* at 928 (emphasis in original) (quoting *Forman*, 421 U.S. at 850-51).

79. *Id.* at 928-29.

80. *Id.* at 931.

ate for determining the initial question of federal jurisdiction.⁸¹ That type of inquiry, *Bronstein* holds, is only required in *Forman*-type cases where the stock does not exhibit traditional characteristics.⁸²

The defendant's reliance on cases which applied an investment contract analysis to the sale of a partnership interest was dismissed by the *Bronstein* court. The fact that the plaintiff's interest in the enterprise took the form of stock and not the form of "some other less easily defined interest" was dispositive of the issue.⁸³

The promissory note cases were distinguished by the court on the basis that notes, unlike stock, may be of either a commercial or an investment nature. Although literally within the definition of a security, commercial notes are excluded from coverage because federal securities laws were not intended to protect commercial loan transactions.⁸⁴ The court determined that shares of stock in a business cannot have commercial characteristics because stockholders acquire their interests in order to participate in a profit-making enterprise, not for personal use of the underlying interest.⁸⁵ In addition, the court expressed concern that application of an investment contract analysis to shareholder situations could lead to the exclusion of stock owned by persons holding management positions from the protections of federal securities laws.⁸⁶

The cases examined in the preceding discussion persuasively support an argument that any sale of stock incident to the transfer of ownership of a business is a securities transaction within the protection of the federal laws. This conclusion, however, is not dictated by the decisions of the Supreme Court. The compelling reasons for a conclusion to the contrary are set forth below.

81. *Id.* at 929.

82. *Id.*

83. *Id.* at 930 n.4 (emphasis added).

84. *Id.* at 930.

85. *Id.*

86. *Id.* at 931. The court noted that such a conclusion would be contrary to precedent regarding corporate insider liability. *Id.* In fact, decisions on insider liability, e.g., *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), can be read consistently with results achieved under the investment contract analysis. Where an insider uses privileged knowledge to defraud through a stock transaction, whether the insider exercises managerial control will be irrelevant. The focus should be on the party claiming the protection of federal securities laws—the defrauded party. That party's control and influence over the corporation will determine whether a security transaction exists. See note 76 *supra*. In most cases, the one defrauded will have either purchased or sold a minority interest in the enterprise and accordingly, under the investment contract analysis, a securities transaction will exist.

IV. AN ARGUMENT FOR THE APPLICATION OF THE INVESTMENT CONTRACT ANALYSIS TO STOCK TRANSFERS

The section argues that a modified investment contract formula should be applied to all stock transactions. The history of the *Howey* formula supports this thesis. Prior to *Howey*, the Securities Exchange Commission⁸⁷ and lower federal courts had used the formula as a general definition for a security.⁸⁸ The Supreme Court later appropriated the formula, using it in *Howey* to define the specific term "investment contract."⁸⁹ Along with "notes" and "stock," the term "investment contract" is included within the statutory list of instruments falling within the definition of a security.⁹⁰ Thus, through *Howey*, the general security definition became associated with one type of security instrument—investment contracts.

The Supreme Court has repeatedly stressed that economic realities and substance, rather than form, should govern the broader question of what is a security.⁹¹ The Court propounded the investment contract analysis to aid in determining the economic reality of a transaction and has applied it in various situations.⁹² If the

87. "[The Securities Exchange Commission] has suggested as a definition of the general term 'security' the following: 'The investment of money with the expectation of profit through the efforts of other persons.'" SEC v. Universal Serv. Ass'n, 106 F.2d 232, 237 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940).

88. See, e.g., SEC v. Universal Serv. Ass'n, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940); SEC v. Pyne, 33 F. Supp. 988 (D. Mass. 1940). For a history of the development of the formula see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 146-59 (1971).

Commentators have called for uniform criteria to determine securities transactions. See generally Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Long, *supra* at 173-74. Note, however, that Professor Long has suggested a formula that focuses on whether the instrument representing the transaction grants the investor a right to participate in the direct management of the enterprise. If the instrument itself grants a right of direct control, the instrument is not a security. If the instrument does not grant a right to control the enterprise, then the instrument is a security. See Long, *supra* at 170-71 & n.158. Majority shareholders, as a rule, will be in a position to control their investments. The control results from owning a large block of votes, not from a right specified in an individual share of stock. Therefore, since a share of stock does not grant a right of direct control to the shareholder, stock transactions would always be securities under Long's formulation. Although Professor Long calls for a uniform test based on "meaningful" criteria, he ultimately arrives at a mechanical formula where form, once again, is elevated over substance.

89. 328 U.S. at 298-99.

90. See notes 6, 7 *supra*.

91. See, e.g., *Howey*, 328 U.S. at 298.

92. See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (applying investment contract test to withdrawable capital shares).

investment contract analysis generalizes the relevant economic realities in a transaction using securities (and the Court has indicated that it does)⁹³ then it should be equally applicable to the testing of stock transactions for securities purposes. Thus, the use of the analysis should not be restricted solely to definition of the term "investment contract."

To reiterate, the *Howey* formula is an investment of money, in a common enterprise, with an expectation of profits to be derived solely from the efforts of others. Since the elements of the formula have been exhaustively treated by commentators,⁹⁴ the following discussion will focus only on the third element of the test—profits to be derived solely from the efforts of others. In cases involving stock transfers incident to the sales of businesses, this element will most frequently determine whether the securities laws apply.

The modern trend among federal and state courts has been to modify the *Howey* formula's third element.⁹⁵ Rather than excluding all investors who contribute their own efforts toward the success of their investments from the securities protections, the courts have focused on the quality of effort that the investor contributes to the enterprise. Thus, in *SEC v. Glen W. Turner Enterprises, Inc.*,⁹⁶ the Ninth Circuit adopted a more flexible test: "[W]hether 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." This approach is compatible with the Supreme Court's intent in *Howey*. For example, in *Forman* the Court referred to the essential attributes of a security as "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."⁹⁷

93. See *Forman*, 421 U.S. at 851-52, quoted at note 30 *supra*.

94. See, e.g., Coffey, note 88 *supra*; Long, note 88 *supra*; Newton, *What is a Security?: A Critical Analysis*, 48 Miss. L.J. 167 (1977).

95. See generally Newton, *supra* note 94, at 192-98.

96. 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973). *Turner* is the leading federal court decision modifying the *Howey* formula. See generally Comment, *What Is a Security? Howey, Turner Enterprises, and Franchise Agreements*, 22 KAN. L. REV. 55, 70-78 (1973). State courts have suggested other tests and/or modifications of *Howey* for a determination of a securities transaction. See, e.g., *Silver Hills Country Club v. Sobieski*, 13 Cal. Rptr. 186 (1961) (en banc); *State v. Hawaii Market Center, Inc.*, 485 P.2d 105 (Haw. 1971).

97. 421 U.S. at 852. Language in *Howey* also reflects this approach: "Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise." 328 U.S. at 300 (emphasis added).

The modified *Howey* formula is also consistent with the purposes of the federal securities laws which were enacted in response to the national crisis following the stock market crash of 1929.⁹⁸ The philosophy behind the acts is one of full disclosure.⁹⁹ Investors who rely upon others for the profits they expect to earn from their investments are thus protected by the disclosure and fraud provisions of the securities acts. Participating investors who manage or who retain practical control over the enterprise presumably have access to essential information and are in a position to control the success of their investment.¹⁰⁰ Hence, the third part of the modified *Howey* formula excludes participating investors from securities protections. Federal protection is properly limited by the managerial efforts element to those lacking practical control over their investments.¹⁰¹ One area where courts routinely apply the managerial efforts element to limit the scope of federal protection is in partnership transactions.¹⁰² For example, general partnerships have been held not to constitute a security because the partners do not rely on the managerial efforts of others for their profits.¹⁰³ Limited partners, on the other hand, do rely on the managerial efforts of others to realize a return on their investment and so are included within the protections of the acts.¹⁰⁴ The business relationships of the parties in *Coffin* and *Bronstein* were similar to partnerships. The parties could have achieved the same distribution of managerial functions and the same fractional interests in the businesses through a partnership, instead of a corporate form. Had a partnership been chosen, the fact patterns of the two cases,

98. See generally L. LOSS, SECURITIES REGULATION 119-21 (Temp. Student Ed. 1961).

99. See generally L. LOSS, *supra* note 98, at 121-28.

100. See, e.g., *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) ("The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do."); *Hirsch v. duPont*, 396 F. Supp. 1214, 1224 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977) ("[W]here the investor obtains managerial control and thereby gains access to information . . . he has less need of the protection . . . of the securities laws.")

101. See generally Newton, *supra* note 94, at 187-88.

102. See generally Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581 (1972).

103. See, e.g., *Vincent v. Moench*, 473 F.2d 430 (10th Cir. 1973); *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977); *Romney v. Richard Prows, Inc.*, 289 F. Supp. 313 (D. Utah 1968). Where the general partnership actually involves control over the enterprise by some partners, to the exclusion of other partners, a security will be found to exist. See *Pawgan v. Silverstein*, 265 F. Supp. 898 (S.D.N.Y. 1967).

104. See, e.g., *Murphey v. Hillwood Villa Assocs.*, 411 F. Supp. 287 (S.D.N.Y. 1976); *Kroungold v. Triester*, 407 F. Supp. 414 (E.D. Pa.), *aff'd*, 521 F.2d 763 (3d Cir. 1975); *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

rather than the form of the business relationship, would have determined their results. In *Coffin*, the plaintiff was to share equally in the management of the business. Therefore, under the managerial efforts test the transaction would not be a security regulated by federal law. In *Bronstein*, although the plaintiff owned one-third of the business, as a field supervisor he may not have had access to the management records of the business. If the managerial efforts of his brother, the defendant, were the "undeniably significant ones," this transaction would fall within the securities acts.

Of course, this type of approach requires the courts to examine the facts of each case. The *Bronstein* court, however, was reluctant to delve beyond the label "stock" to make a threshold jurisdictional determination.¹⁰⁶ The argument that an examination of facts is not appropriate or desirable when making a determination of jurisdiction has little merit when one considers that factual examinations are routinely made in partnership and promissory note cases for jurisdictional purposes.

Some courts have also claimed that application of the investment contract analysis to stock transactions will lead to arbitrary results. For example, the *Occidental* court expressed concern that small interests and controlling interests would be treated differently.¹⁰⁶ In one sense this concern may be justified. The investment contract formula mandates individualized treatment based upon the facts of the case. The applicability of federal securities laws will depend on whether the investor exercises significant managerial functions in the enterprise.¹⁰⁷ This test requires courts to examine the degree of managerial control to be exercised by the investor. The analysis will be more difficult because the line separating securities from nonsecurities will not be clear-cut. Functional, rather than formal dependency will become the touchstone of decision. The consistency achieved by automatically characterizing all stock as "securities" will be lost. But the form of a business relationship should not determine the applicability of federal laws. Whether the relationship takes the form of a partnership, an outright sale of the business' assets, or an acquisition of a business through a stock purchase, the transaction should be governed by the same criteria. Use of the investment contract analysis will result in more uniform treatment for equitably similar transactions.

105. 407 F. Supp. at 929.

106. 496 F.2d at 1263.

107. Witness the possible divergent outcomes in *Bronstein* and *Coffin* under an investment contract approach.

This approach has been taken by courts in promissory note cases. Notes, like stock, are instruments literally included in the statutory definitions of a security.¹⁰⁸ Courts, however, have used the investment contract analysis in promissory note cases to determine securities act coverage in accordance with the economic realities of the transaction.¹⁰⁹ The Seventh Circuit's decision in *Emisco Industries, Inc. v. Pro's, Inc.*¹¹⁰ demonstrates the application of the investment contract analysis to a promissory note. In *Emisco*, the plaintiff company purchased a business from the defendant company. As part of the payment for the assets of the business, the plaintiff gave the defendant a promissory note. After the purchase, the plaintiff brought suit in federal court claiming that material misrepresentations had been made regarding the business.¹¹¹ The Seventh Circuit stated that although the statutory definition includes "any note" within its terms, the beginning phrase of the definition is "unless the context otherwise requires."¹¹² Therefore, not all notes are securities; whether a particular note is a security depends on the factual context of the case.¹¹³

The plaintiff argued that the investment in the assets of the business should be protected by securities laws. The managerial efforts criterion of the investment contract formula had been met, the plaintiff company argued, because it had relied on the defendant's past efforts (to build up the business of the company) in deciding to acquire it and assume control.¹¹⁴ The court stated that past efforts would not satisfy the test: "The important element for the transaction to constitute an investment is that [the plaintiff] relied on present and future efforts of another to produce profits."¹¹⁵ Because the plaintiff had purchased the business and planned to operate it, he was not relying on the present or future efforts of some-

108. Note that the 1934 Act expressly excludes short-term commercial paper (*i.e.*, promissory notes with a maturity date within 9 months of issuance) from the definition of a security. *See note 7 supra*. The 1933 Act, on the other hand, does not exclude short-term paper from the statutory definition of a security, *see note 6 supra*, but the Act does exempt it from registration. 15 U.S.C. § 77c(a)(3) (1976).

109. *See, e.g.*, *Oliver v. Bostetter*, 426 F. Supp. 1082 (D. Md. 1977); *Tri-County State Bank v. Hertz*, 418 F. Supp. 332 (M.D. Pa. 1976); *Sea Pines of Virginia, Inc. v. PLD, Ltd.*, 399 F. Supp. 708 (M.D. Fla. 1975). *But see Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1136 (2d Cir. 1976).

110. 543 F.2d 38 (7th Cir. 1976).

111. *Id.* at 39.

112. *Id.* *See notes 6, 7 supra*.

113. 543 F.2d at 39.

114. *Id.* at 40.

115. *Id.* at 41.

one else. Therefore, the court held that the note was not a security.¹¹⁶

The facts of *Emisco* are similar to the facts of *Titsch* and *Occidental*. In all three cases the sale of an ongoing business was contemplated, and an instrument literally covered by the securities definitions was used. But in *Titsch* and *Occidental* the instrument's label precluded further inquiry, while in *Emisco* the court held that the language "unless the context otherwise requires" mandates an examination of the factual context in which the instrument is used.

The approach taken in *Emisco* would seem to be an equally valid approach in stock transfer cases, but courts have not yet applied the investment contract analysis to stock transfers.¹¹⁷ Decisions that the investment contract formula is inappropriate because "stock" is an instrument explicitly named in the federal statutes have relied heavily on Supreme Court dicta that instruments may "as a matter of law" be securities.¹¹⁸ Therefore, in order to evaluate the rejection of the investment contract analysis by these courts, an examination of the Supreme Court's treatment of the analysis will be necessary.

In *SEC v. C.M. Joiner Leasing Corp.*,¹¹⁹ the Supreme Court declined to establish a general definition either for "securities" or "investment contracts." The question presented was whether the sale of assignments of oil leases in conjunction with a promise to drill exploratory wells was a securities transaction.¹²⁰ The Joiner company argued it was simply selling leasehold interests and that since such instruments were not mentioned in the statutory definition, they were not securities.¹²¹ The Court indicated that the existence of a security is not determined by the nature of the assets underlying the instrument but by "what character the instrument is given in commerce by the terms of the offer, the plan of distribu-

116. *Id.*

117. In *Chandler* and *Bula*, the two decisions holding that acquisition of a business through a stock purchase is not a security, the three-part investment contract analysis was not used. Rather, both courts simply focused on the underlying transaction. Because the underlying transaction in each case was actually the sale of a business, the courts held that a security transaction did not exist.

118. See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943); *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967) (citing *Joiner*).

119. 320 U.S. 344 (1943).

120. *Id.* at 348.

121. *Id.* at 350.

tion, and the economic inducements held out to the prospect."¹²² In dictum the Court also stated that instruments may, as a matter of law, be within the definition, "if on their face they answer to the name or description."¹²³

Three years later, in *Howey*, the Supreme Court set forth the investment contract formula. The Court stressed the protective function of securities acts and suggested that economic realities should govern whether a transaction is a security.¹²⁴ The facts of *Joiner* and *Howey* are similar; in both cases the defendants contended that the underlying transactions were interests in land and therefore were not securities.¹²⁵ The Court, however, concluded in both cases that more than land was involved; the promoters were promising to develop the interest after the sale and the purchasers were relying on those promises for a return on their investment.¹²⁶ This accounts for the statement that security status is determined by the "character the instrument is given in commerce" and not by the assets underlying the instrument. *Joiner* did not involve a simple sale of a leasehold interest since the promoters were making promises for future development. *Howey* was similarly concerned with promoters' promises that they would further develop the "assets" after the sale. The *Howey* Court pointed to the distinction between a simple commercial transaction and the sale of a security in its statement that "[the plaintiffs] have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment."¹²⁷

When the sale of an entire business is made by means of a stock transfer, the "character of the instrument in commerce" should not be interpreted to mean that stock containing "traditional characteristics" is automatically a security. If inducements to purchasers of further development do not accompany the sale of a business interest, that sale should not be considered a security for purposes of federal securities laws.

In both *Howey* and *Joiner*, the Court examined the underlying circumstances of the transactions and determined that securities, not simple commercial transactions, were involved. In *Forman*, the Court also examined the underlying elements of the transaction,

122. *Id.* at 352-53.

123. *Id.* at 351.

124. *Howey*, 328 U.S. at 298-99. See generally note 29 *supra*.

125. *Joiner*, 320 U.S. at 352; *Howey*, 328 U.S. at 299.

126. *Joiner*, 320 U.S. at 348; *Howey*, 328 U.S. at 299.

127. 328 U.S. at 300.

but this time excluded the transaction using essentially the same functional securities definition. A security transaction is not present, the Court noted, where the purchaser buys property for his personal use.¹²⁸ The Court pointed out that the observation in *Joiner* that instruments as a matter of law may be securities was merely dictum; an absolute barrier to inquiry into the economic realities underlying a transaction had not been thereby established.¹²⁹

The courts which rely on *Forman* as authority to include stock as a security point out that the Court first focused on the traditional characteristics of the stock. In addition, the Supreme Court's concern that the term "stock" will lead a purchaser to rely on the protection of the securities laws when the "underlying transaction embodies some of the significant characteristics typically associated with the named instrument," has been deemed important.¹³⁰

The *Forman* Court, however, did not hold that automatic inclusion results when traditional characteristics of stock are present. In fact, the literal approach was rejected by the *Forman* Court¹³¹ and the Court stressed economic realities both when it analyzed the stock for traditional characteristics and when it analyzed the stock under the investment contract formula.¹³² If the economic realities demonstrate that the investor is not relying on the significant managerial efforts of others, the stock should not be held to be a security for federal purposes.

An obstacle to the above analysis is the Court's dictum in *Forman* that the name given an instrument is relevant where the accompanying characteristics might cause a plaintiff to believe that federal securities laws apply.¹³³ Nevertheless, a plaintiff's reliance on securities protections should not be assumed in sales of small businesses. Most purchasers will not consider whether federal se-

128. 421 U.S. at 858.

129. *Id.* at 850.

130. See *Bronstein*, 407 F. Supp. at 931.

131. The Court stated, "We reject at the outset any suggestion that the present 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.* at 848 (footnote omitted). Furthermore, the Court supported its rejection of the literal approach to stock transactions by referring to the analogous promissory note cases. *Id.* at 849 n.14.

132. *Id.* at 848, 851. The *Forman* Court also indicated that no difference exists between an investment contract and the generic term "security." *Id.* at 852, quoted at note 30 *supra*.

133. *Id.* at 850-51.

curities laws are applicable. Certainly such concerns are not of top priority during the negotiation phase of a business deal. Only when the deal turns sour and a plaintiff attempts to find a remedy will the federal laws, and their protections, come to mind. Consequently, it is highly artificial for courts to presume that such reliance exists.¹³⁴ Only the investment contract analysis should be utilized to determine whether a particular stock transaction makes a party an investor, and thereby justifies treatment of the stock or other assets as a "security" for federal purposes.

V. CONCLUSION

One commentator has suggested that the day may come "when it will be said of securities laws—as it has been similarly said of heaven [and] the Internal Revenue Code, . . . that 'not a sparrow falls without the securities laws nodding their assent.'"¹³⁵ But recent Supreme Court decisions have indicated a desire to restrict the scope of the securities laws to the purposes for which the acts were designed.¹³⁶ Since the investment contract formula is designed to effectuate the purposes of the securities acts, the formula should be applied to exclude from federal regulation all transactions involving a stock transfer that is merely incidental to the acquisition of a business.

134. On the other hand, proof of actual reliance on federal protections, (e.g., the promoter's inducements include a claim that the securities laws apply) probably should be considered when determining whether federal law applies.

135. Coffey, *supra* note 88, at 368 n.9.

136. See generally Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. J. 891 (1977); Newton, note 10 *supra*.

