THE SALE OF A CLOSE CORPORATION THROUGH A STOCK TRANSFER: COVERED BY THE FEDERAL SECURITIES LAWS?

INTRODUCTION

Transactions involving the purchase or sale of securities are generally regulated under federal law by the Securities Act of 1933[1] (the 1933 Act) and the Securities Exchange Act of 1934[2] (the 1934 Act). The jurisdiction of these regulatory provisions essentially depends on two factors. The transaction must employ a facility of interstate commerce or the mails[3] and must involve a "security."[4] Both Acts explicitly define the term security[5] and though the language of each defini-

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[1] 15 U.S.C. §§ 77a to 77aa (1976).

[2] 15 U.S.C. §§ 78a to 78kk (1976). There are four other basic federal securities acts besides the 1933 and 1934 Acts. These are: the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1976); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbbb (1976); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1976); and the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1976). The focus of this comment will be limited to the 1933 and 1934 Acts.

[3] Congress' domestic regulatory power over commerce is constitutionally limited to interstate commerce. U.S. CONST. art. 1, § 8, cl. 3. Consequently, there is an overriding limitation on the application of the securities laws which is spelled out within the language of the statutory provisions. For example, violations of the 1933 Act's mandates governing registration requirements and the use of a prospectus are premised on the use of "any means or instruments of transportation or communication in interstate commerce or of the mails." 15 U.S.C. § 77e(a)(1), (b)(1) & (c) (1976). Similarly, operation of the principle anti-fraud provisions of the 1933 and 1934 Acts is limited to situations involving interstate commerce or the use of the mails. 15 U.S.C. § 77l(2) (1976) (§ 12(2) of the 1933 Act); 15 U.S.C. § 77q(a) (1976) (§ 17(a) of the 1933 Act); 15 U.S.C. § 78j(b) (1976) (§ 10b of the 1934 Act); 17 C.F.R. § 240.10b-5 (1980) (rule 10b-5 promulgated pursuant to the 1934 Act).

[4] *E.g.*, Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 334-35 (W.D. Pa. 1980); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 447 (D. Colo. 1978).

[5] The Securities Act of 1933 defines a "security" as follows:

> When used in this subchapter, unless the context otherwise requires—
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> (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).

Section 3 of the Securities Exchange Act of 1934 provides a similar definition of the term "security":

> When used in this chapter, unless the context otherwise requires—
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> . . . .

tion differs slightly, courts have construed the definitions as functional equivalents.[6] Despite these statutory definitions, unresolved questions remain as to the precise ambit of the term security;[7] consequently, the purview of the Acts is not totally certain.

Common to both definitions is the inclusion of "stock" among the instruments specifically enumerated as securities.[8] Each definition is also prefaced by the clause "unless the context otherwise requires."[9] This qualification creates an element of flexibility in the application of these definitions. As a result, instruments labelled stock are not automatically considered securities because the "context" may require otherwise.[10]

The problem of determining when stock is a security has been a subject of recent debate in the context of the sale of close corporations through the transfer of corporate stock. Specifically, the question has been whether such a sale constitutes a securities transaction or merely a commercial purchase of a business. Two recent federal court decisions have addressed this question and have reached conflicting results. In *Mifflin Energy Sources, Inc. v. Brooks*,[11] the District Court for the Western District of Pennsylvania determined that the sale of a

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> (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, preorganization 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).

[6] United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 847 n.12(1975) (Supreme Court treated two definitions synonymously when considering "the coverage of the two Acts"). *See* Tcherepnin v. Knight, 389 U.S. 332, 336, 342 (1967); United Cal. Bank v. THC Financial Corp., 557 F.2d 1351, 1356 (9th Cir. 1977); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 334 (W.D. Pa. 1980).

[7] *See* Newton, *What is a Security? A Critical Analysis*, 48 MISS. L.J. 167, 167, 198 (1977); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 219 (1974).

[8] 15 U.S.C. § 77b(1) (1976); 15 U.S.C. § 78c(a)(10) (1976). *See* note 5 *supra*.

[9] *See* note 5 *supra*.

[10] *E.g.*, United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975) (stock in cooperative housing complex found not to constitute a security); Fredericksen v. Poloway, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,815 (7th Cir. 1981) (sale of marina where purchaser received 100% stock transfer, not sale of securities); Chandler v. Kew, Inc., [1979] FED. SEC. L. REP. (CCH) ¶96,966 (10th Cir. 1977) (purchase of 100% of company's stock held not to be purchase of securities).

[11] 501 F. Supp. 334 (W.D. Pa. 1980).

small strip mining business through the purchase of 100% of the company's stock constituted a securities transaction.[12] Conversely, the Court of Appeals for the Seventh Circuit found in *Frederiksen v. Poloway*[13] that the sale of a boat marina in which the purchaser received 100% of the corporation's stock was not a securities sale within the meaning of federal law.[14] These cases are significant in that they typify the general split in the federal courts on this issue[15] and illustrate the reasoning characteristic of each conflicting view. As will be discussed, the principal reason for this split stems from the different interpretations given the United States Supreme Court's decision in *United Housing Foundation, Inc. v. Forman.*[16] Though factually distinct from cases dealing with business acquisitions through the purchase of corporate stock, *Forman* remains the seminal case defining the meaning of the term stock for purposes of the 1933 and 1934 Acts.[17]

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[12] *Id.* at 336. The *Mifflin* court attempted to distinguish conflicting precedent by focusing on the structure of the transaction. Because the sales contract was titled a "stock purchase agreement," the court found that the stock transfer represented the "substance" of the transaction rather than the symbolic conveyance of an "indicia of ownership." *Id.* Other cases have drawn a similar distinction between a stock conveyance that is the "substance" of the sale of the business and a conveyance that is part of the sale but merely "incidental" to the transfer of ownership. *E.g.*, Chandler v. Kew, [1979] FED. SEC. L. REP. (CCH) ¶96,966, at 96,054 (10th Cir. 1977); Bula v. Mansfield [1979] FED. SEC. L. REP. (CCH) ¶96,964, at 96,052 (D. Colo. 1977). Such a factual distinction is questionable and fails to provide an adequate rationale for the different result reached. *See* Defendant's Petition for Leave to Appeal at 11, Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334 (W.D. Pa. 1980). As will be discussed, the basic premise of *Fredericksen* and similar cases is that all sales of businesses should receive similar treatment. Whether the transfer of stock is the "substance" of the overall transaction or merely a by-product should be immaterial since in either case the "economic reality" is the sale of a business. For purposes of this comment, it will be assumed that all sales of businesses involving stock transfers are equivalent.

[13] [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,815 (7th Cir. 1981).

[14] *Id.* at 90,076.

[15] In addition to *Mifflin* and *Fredericksen*, other reported cases have approached this problem. Those finding jurisdiction of the federal securities laws include: Coffin v. Polishing Mach., Inc., 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 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); and Bronstein v. Bronstein, 407 F. Supp. 925 (E.D. Pa. 1976). Those cases failing to find a securities transaction are: Chandler v. Kew, [1979] FED. SEC. L. REP. (CCH) ¶96,966 (10th Cir. 1977); Barsy v. Verin, 508 F. Supp. 952 (E.D. Ill. 1981); Dueker v. Turner, [1980] FED. SEC. L. REP. (CCH) ¶97,386 (N.D. Ga. 1979); Bula v. Mansfield, [1979] FED. SEC. L. REP. (CCH) ¶96,964 (D. Colo. 1977).

[16] 421 U.S. 837 (1975).

[17] The Supreme Court has on several other occasions attempted to give meaning to the term "security." *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959); SEC v. W.J. Howey & Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

This comment will analyze these two recent cases, examine the basic reasons for their differing results, and suggest that a proper analysis would include stock transfers of this nature within the purview of the federal securities laws.

I. *UNITED HOUSING FOUNDATION, INC. v. FORMAN*

The plaintiffs in *Forman* were tenants[18] of Co-op City, a large low-cost, state subsidized cooperative housing complex.[19] Like all Co-op City tenants, they had been required to purchase stock in the cooperative as a precondition to receiving a lease.[20] Under the cooperative agreement, a tenant purchased eighteen shares of stock for each apartment room to be leased and paid a relatively small monthly rental charge.[21] The bulk of the monthly charge was used by the management of Co-op City to meet payments on a low-interest state mortgage used to finance the project's construction.[22]

The principal controversy in the case related to the accuracy of certain information contained in a promotional bulletin circulated by United Housing Foundation, Inc. (UHF), Co-op City's chief planner. Indicated within the bulletin was the expected monthly rental fee based on initial building cost estimates.[23] The bulletin also stated that Community Services, Inc. (CSI), the project's general contractor and a wholly-owned subsidiary of UHF, would bear any additional construction costs resulting from inflation.[24] When actual construction expenditures exceeded estimates, however, UHF made up the

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[18] 421 U.S. at 844. The action was brought by 57 residents of Co-op City on behalf of over 15,000 apartment owners in that same complex. Over $30 million in damages were sought plus "forced rental reductions, and other appropriate relief." *Id.*

[19] *Id.* at 840-41. Co-op City is a massive multi-structure apartment complex located in New York City. Its construction was initiated by the United Housing Foundation, a non-profit housing development corporation established for the purpose of promoting the creation of safe and adequate housing for people of "low or moderate income." *Id.* at 841.

[20] *Id.* at 842, 844. The stock was issued by Riverbay Corporation, a non-profit corporation established by the United Housing Foundation to own and manage Co-op City. *Id.* at 841.

[21] *Id.* at 842-43.

[22] *Id.* at 843. Financing for the project was obtained from the State of New York pursuant to the Mitchell-Lama Act, N.Y. PRIV. HOUS. FIN. LAW §§ 10-37 (McKinney 1976 & Cum. Supp. 1980-1981), enacted to help remedy a perceived shortage of low-income urban housing. 421 U.S. at 840-41. Under the Act, developers of such housing qualify for long-term, low-interest mortgage loans from the state if they agree to operate the facility on a non-profit basis. N.Y. PRIV. HOUS. FIN. LAW § 11-a(2-a) (McKinney 1976). In addition, the developer may lease apartments only to individuals whose monthly income does not exceed a designated percentage of the monthly rental fee. *Id.* § 31(2)(a).

[23] 421 U.S. at 843-44. The average monthly fee was originally estimated at $23.02 per room. This amount was based on a total projected construction cost of $283,695,550. *Id.* at 843.

[24] *Id.* at 844.

difference by borrowing additional funds from the state.[25] This translated into higher interest premiums on the state loan and consequently higher monthly charges to tenants than those indicated in the bulletin.[26]

The plaintiffs brought suit in federal district court alleging violations of anti-fraud provisions of the 1933 and 1934 Acts.[27] The crux of their complaint was that they had been induced to purchase stock in Co-op City by the fraudulent representations in the information bulletin that CSI would assume additional costs, when in reality the tenant-shareholders were forced to cover the difference through increased monthly rent.[28]

The district court dismissed the action for lack of federal jurisdiction, finding that the Co-op City stock was not a security for purposes of federal law.[29] In so holding, the court rejected the argument that all stock should be accorded federal securities law coverage simply because stock is within the literal definition of a security.[30] Instead, when the substance rather than the form of the instruments was examined, it was apparent that the Co-op City shares, offering no prospect of profit, were not stock in the general commercial sense and hence not stock within the 1933 and 1934 Acts.[31]

Furthermore, the district court refused to recognize the shares as "investment contracts"—another type of security within the statutory definition of a security[32]—because they did not meet the test for determining the existence of an investment contract as set forth by the Supreme Court in *SEC v. W.J. Howey & Co.*[33] Under that test, an

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[25] *Id.* The final construction costs were $125 million more than the estimates stated in the information bulletin. *Id.*

[26] *Id.* The average monthly rental fee "increased periodically" until it reached a figure of $39.68 per room by the middle of 1974. *Id.*

[27] *Id.* at 844-45. *See* Forman v. Community Servs., Inc., 366 F. Supp. 1117 (S.D.N.Y. 1973). Specifically, plaintiffs alleged violations of § 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1976), section 10b of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1976), and rule 10b-5. 17 C.F.R. § 240.10b-5 (1980). Forman v. Community Servs., Inc., 366 F. Supp. 1117, 1120 (S.D.N.Y. 1973).

[28] 421 U.S. at 844. In addition to allegations of fraudulent misrepresentation, the plaintiffs claimed that several material facts were omitted from the information bulletin. For example, it was averred that UHF knew that the initial cost estimates would not be adhered to based on its past building experience. Furthermore, the relation between UHF and CSI was alleged to have been inadequately disclosed. *Id.* at 844 n.8.

[29] *Id.* at 845.

[30] *Id.* at 845-46. *See* note 5 *supra* and accompanying text.

[31] 421 U.S. at 845-46.

[32] 15 U.S.C. §§ 77b(1) & 78c(a)(10) (1976). *See* note 5 *supra*.

[33] 328 U.S. 293 (1946). In *Howey*, the Supreme Court held that the purchase of units of land in a citrus grove coupled with a service contract for the cultivation, harvest, and marketing of the land's fruit yield amounted to an investment contract. *Id.* at 299.

investment contract requires "an investment of money in a common enterprise with profits to come solely from the efforts of others."[34]

On appeal, the Court of Appeals for the Second Circuit reversed the district court's decision to dismiss and remanded for proceedings on the merits.[35] Judge Oakes accepted the literal approach urged by the plaintiffs, determining that since the shares were labelled stock they explicitly fell within the definition of a security.[36] It was also found that the shares qualified as investment contracts due to several sources of potential profit inherent in the cooperative arrangement.[37]

In a six to three decision, the Supreme Court reversed the court of appeals' ruling and affirmed the district court's finding of no jurisdiction.[38] The majority opinion, authored by Justice Powell, discussed both the literal approach and the investment contract theories. In part A of the opinion, the Court expressly rejected the notion that the labelling of an instrument as stock qualifies it as a security "simply because the statutory definition of a security includes the words 'any . . . stock.' "[39] According to the majority, application of the federal securities laws was intended by Congress "to turn on the economic realities" of the transaction and not the name affixed to the instruments involved.[40]

Assessing the economic realities of the Co-op City stock, the Court found that the shares embodied "none of the characteristics" traditionally associated with stock.[41] By the terms of the cooperative's corporate charter, the stock carried no right to receive dividends, was non-transferable, could not be pledged or encumbered, and conveyed "no voting rights [based on] the number of shares

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[34] *Id.* at 301. In finding that the scheme in *Howey* constituted an investment contract rather than the sale of real estate, the Court focused on the fact that investors had no intent to occupy the land nor was it economically feasible to generate any profit through individual efforts. In short, each person was prompted to part with his money by the prospect of profits deriving from the managerial skills of others. *Id.* at 300.

The district court in *Forman* found that the Co-op City shares failed the investment contract test. In its view, the purchasers were not induced by the expectation of any potential pecuniary profit since the stock could not be re-sold in excess of cost. 421 U.S. at 842-43. *See* note 43 *infra.*

[35] Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974).

[36] *Id.* at 1252-53.

[37] *Id.* at 1254. The court noted that tenants received a tax deduction for that portion of their rent attributed to paying the mortgage interest. Also significant was the savings in rent afforded by the low-cost cooperative development plus the possibility of further reductions resulting from the income generated by the leasing of Co-op City's commercial facilities. *Id.*

[38] 421 U.S. at 860.

[39] *Id.* at 848.

[40] *Id.* at 849.

[41] *Id.* at 851.

owned." [42] Furthermore, the shares held no prospect of capital appreciation since a tenant who moved could not sell the stock for a price exceeding original cost.[43] Thus, the Court concluded that "the inducement to purchase" the shares was to acquire low-cost housing and not to "invest for profit." [44]

Part B of the opinion focused on the claim that the shares amounted to an investment contract.[45] The Court began its analysis by reiterating the *Howey* test and summarized that an investment contract essentially requires the "expectation of profits . . . derived from the . . . managerial efforts of others."[46] Applying that test to the cooperative stock, Justice Powell found that there was no possibility of profit since the shares could neither appreciate in value nor did they entitle their holders to any participation in earnings.[47] In short, the absence of any meaningful expectation of profit negated the possibility of Co-op City stock meeting the *Howey* test of an investment contract.[48]

II. *MIFFLIN* AND *FREDERICKSEN*

The *Forman* decision was pivotal to the courts in both *Mifflin Energy Sources, Inc. v. Brooks*[49] and *Fredericksen v. Poloway*.[50] Yet,

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[42] *Id.* The Co-op City charter did not provide for one vote per share; instead, each apartment carried only one vote as to matters of general tenant interest. *Id.* at 842.

[43] *Id.* at 842-43, 851. Under the cooperative agreement, a tenant terminating his occupancy was required to offer his shares to Riverbay at their initial cost. If Riverbay refused to repurchase the stock, a tenant could sell to an outside party meeting the income eligibility requirements, but only at initial price plus a fraction of his contribution to the state mortgage payments. *Id.* at 842-43.

[44] *Id.* at 851.

[45] *Id.*

[46] *Id.* at 852.

[47] *Id. See* note 43 *supra*. In his dissent, Justice Brennan criticized the majority's narrow definition of profits. In his view the concept of profit is not limited to capital appreciation or participation in earnings; rather, the benefits cited by the court of appeals should also be considered profit since they "accrue to the resident-stockholders in the form of money saved." 421 U.S. at 863 (Brennan, J., dissenting) (footnote omitted).

[48] 421 U.S. at 853. Each of the three bases for profit found by the court of appeals was examined by the Court and rejected as unpersuasive. The Court determined that the deductibility of interest payments on a mortgage could not be viewed as income or profits. *Id.* at 855. Furthermore, the money saved on rent due to the state subsidies was no more "income or profits than . . . welfare benefits, food stamps or other governmental subsidies." *Id.* Finally, the prospect of reduced rent stemming from income on commercial leaseholds was "too speculative and insubstantial to bring the entire transaction within" the scope of the securities laws. *Id.* at 856. In any event, the possibility of rent diminution was "never mentioned in the Information Bulletin" and thus was not an inducement to tenants. *Id.*

[49] 501 F. Supp. 334.

[50] [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,815.

each court reached a different conclusion when applying the *Forman* rationale to similar factual circumstances.

In *Mifflin*, the plaintiff purchased a small strip mining company from the defendant. The acquisition of the business was effected through the sale of 100% of the company's stock.[51] Subsequent to the purchase, the buyer brought an action in federal district court alleging fraud in connection with the sale of the stock in violation of the 1933 and 1934 Acts.[52] The defendant moved to dismiss the action for lack of federal jurisdiction, arguing that *Forman* required courts to examine the "economic realities" of a transaction before finding it to be within the scope of the federal securities laws. The seller contended that this type of inquiry would reveal that the transaction was in reality the sale of an on-going business and not the sale of securities.[53]

Judge Weber was not persuaded by the defendant's argument. In his view, *Forman* did not mandate an economic reality analysis where the contract in question was "a stock purchase agreement" and the instruments possessed the traditional attributes of stock.[54] Unlike the shares in a cooperative, the stock in *Mifflin* included such attributes as "the right to receive dividends, negotiability, voting rights, and the potential of appreciation in value." [55] As such, the fact that the transaction resulted in the sale of a business was not determinative of whether the stock should be deemed a security.[56]

A month after *Mifflin* was decided, the Court of Appeals for the Seventh Circuit rendered its opinion in *Fredericksen*. That case involved the acquisition of a marina through the purchase of the business' assets and stock.[57] Under the terms of the purchase agreement, Poloway, the previous owner of the marina, was to remain with the enterprise under a five-year employment contract.[58] When his employment was terminated by the new owner prior to the expiration of the contract, Poloway sued in state court for breach of contract.[59] Shortly thereafter, Fredericksen, the marina's new owner and man-

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[51] 501 F. Supp. at 334.

[52] *Id.* The plaintiff averred that the defendant had violated § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), and § 10b of the 1934 Act, 15 U.S.C. § 78j(b) (1976), by misrepresenting the financial health of the company and by "fail[ing] to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Complaint, ¶9, Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334 (W.D. Pa. 1980).

[53] 501 F. Supp. at 335.

[54] *Id.*

[55] *Id.* at 335-36.

[56] *Id. See* note 12 *supra.*

[57] [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,815, at 90,072.

[58] *Id.*

[59] *Id.* at 90,073.

ager, filed a claim against Poloway in federal district court alleging illegalities under the 1933 and 1934 Acts.[60] The buyer contended that the stock purchased was a security within the meaning of the federal securities Acts and that in connection with the sale of that stock Poloway had omitted and misrepresented certain material facts.[61] The district court dismissed the suit on the ground that the sale did not involve a securities transaction.[62] Fredericksen appealed to the Court of Appeals for the Seventh Circuit.

Judge Sprecher affirmed the lower court's dismissal. Relying on language in *Forman*, he opined that transactions purportedly involving securities must be assessed in the light of their economic reality.[63] He concluded that the reality of the transaction in *Fredericksen* was the acquisition of a "business in its entirety." [64] Similar to the procurement of housing in *Forman*, the sale of the marina stock was unrelated to any investment purpose. It was passed merely as an "indicia of ownership" with the principal purpose of the transaction being the purchase of a business.[65]

III. ANALYSIS

The holdings in *Mifflin* and *Fredericksen* demonstrate the dichotomy in the interpretation of *Forman* typical of cases deciding whether the sale of a business through a stock purchase is a securities transaction. Cases following the *Mifflin* rationale and finding jurisdiction of the federal securities laws have read *Forman* to require only an inquiry into the characteristics of the stock being conveyed.[66] If the shares embody the "significant characteristics" typically associated with corporate stock, it is unimportant that ownership of a business is

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[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.* at 90,074. Judge Sprecher prefaced his analysis with a brief discussion of the goals and purposes of the securities laws. After quoting language from *Forman* to the effect that the "focus" of the laws is on the capital-raising markets, he stated that "the key to defining the scope of the securities laws is whether the transaction is for *commercial* . . . or for *investment* purposes." *Id.* at 90,073 (emphasis added). The court found this distinction significant in determining that there was no offer of "*investment* 'securities.' " *Id.* at 90,075 (emphasis added).

[64] *Id.* at 90,075.

[65] *Id.* As an alternate argument, the plaintiff attemped to convince the court that the transaction fit within the definition of an investment contract. This contention was rejected by Judge Sprecher who found that the *Howey* test was not met since there was no "common venture" and no reliance on the managerial efforts of others. *Id.*

[66] *E.g.*, Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir. 1979); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 447-49 (D. Colo. 1978); Bronstein v. Bronstein, 407 F. Supp. 925, 929 (E.D. Pa. 1976).

being transferred. On the other hand, cases refusing to find a securities transaction have followed the *Fredericksen* interpretation of *Forman* that the "economic realities" of the underlying transaction control the applicability of the securities laws irrespective of the name and characteristics of the instrument.[67] If the reality of the transaction is to transfer ownership of a business, the transaction merely represents a commercial sale not covered by the securities laws.[68]

An argument can be made supporting jurisdiction of the 1933 and 1934 Acts over business acquisitions through the sale of corporate stock. This section will present such an argument by: briefly analyzing the Supreme Court's reasoning in *Forman;* reviewing policies and practical considerations as they relate to stock acquisitions; and evaluating suggested alternative approaches to the classification of securities.

A. Forman

Justice Powell's opinion in *Forman* contains language which can be read to support the results in both *Mifflin* and *Fredericksen.*[69] The Court's decision, however, is tempered by statements appearing at the end of the majority opinion which indicate that the holding is a narrow one, limited to the facts of the case.[70] Consequently, the meaning of *Forman* should not carry the same weight where the factual context is quite different such as in the case of the purchase of a company. Indeed, the acquisition of living space through the purchase of stock is a very different situation from the sale of a business through a stock transfer.

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[67] *E.g.*, Chandler v. Kew, [1979] FED. SEC. L. REP. (CCH) ¶96,966, at 96,054 (10th Cir. 1977); Dueker v. Turner, [1980] FED. SEC. L. REP. (CCH) ¶97,386, at 97,536 (N.D. Ga. 1979); Bula v. Mansfield, [1979] FED. SEC. L. REP. (CCH) ¶96,964, at 96,052 (D. Colo. 1977).

[68] *See* Dueker v. Turner, [1980] FED. SEC. L. REP. ¶97,386, at 97,536 (N.D. Ga. 1979); Bula v. Mansfield, [1979] FED. SEC. L. REP. ¶96,966, at 96,052 (D. Colo. 1977). *Cf.* Lino v. City Investing Co., 487 F.2d 689, 694 (3d Cir. 1973) (purchase of franchise licensing agreements through execution of personal promissory notes held to be commercial rather than securities transaction).

[69] 421 U.S. at 848, 849-50, 851. For example, the Court stated in part A that " '[i]n searching for the meaning and scope of the word "security" in the Act[s], form should be disregarded for substance and the emphasis should be on economic realities.' " *Id.* at 848 (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)). Justice Powell then spoke of "economic reality" as the "economic inducement" in making the transaction. 421 U.S. at 849-50. If the inducement is viewed as the purchase of a business rather than the purchase of corporate stock, arguably the securities laws should not apply.

On the other hand, later in part A the Court suggested that the name attached to an instrument is important if "the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Id.* at 851. The sale of ordinary corporate stock would seem to qualify as a security under this analysis. *See* notes 71-73 *infra* and accompanying text.

[70] 421 U.S. at 859-60. The Court stated that "[w]e decide only that the type of transaction before us, in which the purchasers were interested in acquiring housing rather than making an investment for profit, is not within the scope of the federal securities laws." *Id.*

In addition, a close reading of *Forman* indicates that while the Court will not accept a literal approach to the definition of a security, the name attached to an instrument is not "wholly irrelevant."[71] The appearance of "significant characteristics,"[72] traditionally associated with an instrument contained within the statutory definition of a security, will justify the assumption that the 1933 and 1934 Acts apply.[73] Because none of the traditional elements of stock existed in the Co-op City stock, it could not be said that the shares fell " 'within the ordinary concept of a security.' " [74] On the other hand, stock embodying the usual attributes of corporate stock—the right to receive a portion of income, freedom of alienation, voting rights, possible appreciation in value—will fit within the definition of a security under the *Forman* rationale.[75]

The purchaser's motivation was also a significant factor to the Court. Since the Co-op City stock held no prospect for income or appreciation in value,[76] the majority concluded that the "inducement to purchase was solely to acquire subsidized low cost living space . . . not to invest for profit." [77] This analysis further suggests that the securities laws are applicable to the sale of a business by a stock transfer. If the recognition of a security depends in part on whether the primary inducement for parting with one's money is an expectation of profit, the purchaser of a close corporation through a stock transaction should not be denied the protections of the 1933 and 1934 Acts. Undoubtedly, this purchaser is motivated by the same expectations of profit or capital appreciation[78] that induce all investors to part with their money.

B. Other Considerations

The 1933 and 1934 Acts were enacted primarily to remedy the abuses and unscrupulous practices that had prevailed in the virtually

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[71] *Id.* at 850.

[72] *Id.* at 850-51. Note that the Court was vague as to the amount of traditional characteristics necessary to qualify an instrument as a security. The Court simply stated "some" significant characteristics. *Id.* at 851.

[73] *Id.* at 850-51.

[74] *Id.* at 851 (quoting H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933)).

[75] *Id.* at 851. As one commentator has remarked, "[t]he substance-over-form approach in *Forman* properly excludes from [the securities laws] items which, though labelled as 'securities', possess none of their substantive characteristics." Newton, *supra* note 7, at 171 n.28.

[76] 421 U.S. at 842-43. *See* note 43 *supra* and accompanying text.

[77] 421 U.S. at 851.

[78] Note that where the enterprise is successful, such a purchaser may wish to resell some of the stock at an appreciated value.

unregulated securities markets prior to the stock market crash of 1929.[79] Consequently, the provisions of the Acts regulate most extensively securities which are publicly traded.[80] The anti-fraud provisions,[81] however, are not dependent upon the public nature of an offering; [82] nor do they require the involvement of a recognized securities exchange or an organized over-the-counter market.[83] Additionally, the size of the issuing company is irrelevant; securities of closely held corporations are thus put on an equal footing with those of publicly held corporations.[84]

In drafting the securities laws, Congress was particularly concerned with the widespread incidence of fraud and non-disclosure perpetrated against unsuspecting investors.[85] The fundamental policies underlying the 1933 and 1934 Acts are thus two-fold: to require full disclosure of material information and to proscribe fraudulent

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[79] United Hous. Foundation, Inc. v. Forman, 421 U.S. at 849; H.R. REP. No. 85, 73d Cong., 1st Sess. 2-3 (1933); Newton, *supra* note 7, at 168. *See* Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959).

[80] Public offerings generally require filing of a registration statement with the Securities and Exchange Commission in which extensive disclosure of material information is made. 15 U.S.C. §§ 77e to 77g (1976). Section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1976), and rule 146, 17 C.F.R. 230.146 (1980), provide a filing exemption for non-public or private placement offerings.

In the case of a stock purchase resulting in the transfer of ownership of a close corporation, filing will probably not be a problem because the transaction will be exempt if the securities are offered in a non-public manner. Furthermore, § 3(a)(11) of the 1933 Act, 15 U.S.C. § 77(C)(a)(11) (1976), and rule 147, 17 C.F.R. 230.147 (1980), grant a similar exemption in the case of intrastate offerings.

[81] The basic anti-fraud provisions found in the 1933 and 1934 Acts are § 12(2), 15 U.S.C. § 77l(2) (1976), and § 17(a), 15 U.S.C. § 77q(a) (1976) of the 1933 Act, and § 10b, 15 U.S.C. § 78j(b) (1976) of the 1934 Act.

[82] Section 3 of the 1933 Act, 15 U.S.C. § 77c (1976), lists *securities* which are exempt from the filing requirements of that Act. With the exception of certain government obligations, all of these exempted securities are subject to possible § 12(2) claims. Section 17 is applicable to all securities exempted by § 3. 15 U.S.C. § 77q(c) (1976).

Section 4 of the 1933 Act, 15 U.S.C. § 77d (1976), exempts specified *transactions* from the registration and prospectus requirements of § 5. 15 U.S.C. § 77e (1976). Yet, this exemption has no effect with respect to the anti-fraud provisions of the 1933 Act.

Section 10b of the 1934 Act, 15 U.S.C. § 78j(b) (1976), is applicable to the "purchase or sale of *any security* registered on a national securities exchange or *any security* not so registered." *Id.* (emphasis added).

[83] *E.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971); Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960); Fratt v. Robinson, 203 F.2d 627, 629-31 (9th Cir. 1953).

[84] *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960). These cases both involved the sale of a close corporation's stock; yet no special consideration was given this fact.

[85] S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933); H.R. REP. No. 85, 73d Cong., 1st Sess. 2-3 (1933). *See* El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1227 n.7 (9th Cir.), *cert. denied*, 417 U.S. 900 (1974).

practices in order to promote intelligent securities investment.[86] Legislators believed that these goals could not be adequately effectuated under state law;[87] therefore, the ambit of the Acts was intended to afford redress for conduct not compensable in a common law fraud or misrepresentation action.[88]

The perceived need to provide investors with a broad basis for protection under federal law prompted Congress to define the term security in an expansive manner.[89] The objective was to obviate creative schemes aimed at circumventing coverage of the securities laws and to include within the laws' purview "the many types of instruments that in our commercial world fall within the ordinary concept of a security."[90]

Recognizing Congress' intent to enact far-reaching remedial legislation, courts have consistently given the securities laws a broad and flexible construction.[91] Instruments not explicitly referred to within the statutory definition of a security have often been included within the ambit of the 1933 and 1934 Acts by way of the general phrases

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[86] Newton, *supra* note 7, 168. *See* 1 L. Loss, SECURITIES REGULATION 20-23 (1961).

In discussing the 1933 Act, William O. Douglas and George E. Bates stated that "the Act pretends . . . to require the 'truth about securities' . . . and to impose a penalty for failure to tell the truth." Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933).

[87] *See* 1 L. Loss, *supra* note 86, 20-23.

[88] Holloway v. Howerdd, 377 F. Supp. 754, 764 (M.D. Tenn. 1973). At common law, an individual had no affirmative duty to disclose information to others. "[M]ere silence, or a passive failure to disclose facts of which the defendant [had] knowledge" did not constitute wrongful conduct, unless a fiduciary relation was present, W. PROSSER, HANDBOOK ON THE LAW OF TORTS 695-97 (4th ed. 1971), or "special circumstances" existed. Strong v. Repide, 213 U.S. 419, 434 (1909). The securities laws have imposed upon purchasers and sellers of securities a broader obligation to disclose information that is material to that transaction. *See* 15 U.S.C. § 77q(a) (1976); 17 C.F.R. § 240.10b-5 (1980); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

Moreover, due to the broad construction given the antifraud provisions of the securities laws, plaintiffs have had less onerous proof problems than those existing under common law fraud or misrepresentation actions. For example, courts have held that actions brought under rule 10b-5, 17 C.F.R. § 240.10b-5 (1980), do not require a showing of: (1) causation, Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970) ("materiality" rather than causation sufficient); (2) privity with the defendant, Baretge v. Barnett, 553 F.2d 290 (2d Cir. 1977); or (3) improper motive, Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978).

[89] H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933). *See* note 5 *supra*. Both the 1933 Act and the 1934 Act definitions include the term "investment contract" which apparently was provided as a "basket" clause. Serving a similar function is the use of the phrase "any interest or instrument commonly known as a 'security,' " also part of each definition. 15 U.S.C. § 77b(1) (1976); 15 U.S.C. § 78c(a)(10) (1976). *See* note 5 *supra*.

[90] H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

[91] *E.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); Dupuy v. Dupuy, 511 F.2d 641, 643 (5th Cir. 1975). *See* Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (example of early case implying private right of action under section 10b).

"investment contract" or "instrument commonly known as a security." [92]

In view of the goals of the securities laws[93] and the liberal construction given the scope of the laws by courts essaying to carry out these legislative objectives,[94] it would be anomalous to exclude from coverage traditional corporate stock merely because the amount purchased represents the total number of a close corporation's outstanding shares. Such a result would specifically contravene legislative and judicial policy favoring a broad interpretation of the term security. More importantly, the objectives of the securities provisions would be undermined. The protection afforded investors would depend on the amount of stock purchased—those acquiring small parcels receiving protection; those purchasing an ownership interest in a company being relegated to more restrictive common law remedies. This result flies in the face of logic.[95] Regulations concerning disclosure and the prevention of fraud are equally important to all investors, whether large or small. Indeed, the purchaser of a large block of stock is perhaps in greater need of such protection since he stands to lose more by relying on the information disclosed or withheld.[96]

As the *Mifflin* court noted, another important factor to be considered is the manner in which the transacting parties structure a corporate sale.[97] An alternative to conveying ownership through a stock transfer is to sell the company's assets. Such an approach would totally exclude any security from the transaction, thus rendering the provisions of the 1933 and 1934 Acts inapplicable.[98] While the net result of transferring ownership is the same whether assets or shares of stock are conveyed, the parties' conscious selection of the method of the sale must not be disregarded.[99] The decision to employ stock may

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[92] *See* SEC v. W. J. Howey & Co., 328 U.S. 293 (1946); Weaver v. Marine Bank, 637 F.2d 157 (3d Cir. 1980); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

[93] *See* notes 86 & 87 *supra* and accompanying text.

[94] *See* notes 92 & 93 *supra* and accompanying text.

[95] Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc., 496 F.2d 1255, 1263 (4th Cir. 1974).

[96] The court in Titsch v. Hastings, 456 F. Supp. 445 (D. Colo. 1978), was particularly concerned with the fact that in acquiring all the stock of a business a purchaser was assuming the liabilities of that business as well as the assets. The accuracy of the company's balance sheet was a prime consideration in arriving at the stock's purchase price. If material information pertaining to the company's financial health was misrepresented or omitted, the purchaser would be denied securities law protection. Yet, an individual who expended less money and obtained less than full ownership *would* be afforded redress under the laws. *Id.* at 449.

[97] 501 F. Supp. at 336. *See* Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

[98] For example, the parties could structure the transaction as a Type C reorganization where the corporation's assets are sold, yet no stock in the selling corporation is transferred. *See* I.R.C. § 368.

[99] 501 F. Supp. at 336; Titsch v. Hastings, 456 F. Supp. 445, 448-49 (D. Colo. 1978).

be based on the assumption of securities law protection. Of course, the purchaser's motive for choosing stock as the medium for a transaction may be totally unrelated to securities law considerations.[100] Yet, it should not be the role of the courts to second-guess the business decisions of litigants.[101] Moreover, even in the absence of subjective reliance on the applicability of the securities laws, the buyer of all the stock of a business should be afforded the same protections afforded those who transact for less than 100% ownership. This latter group may similarly have no reliance on federal law and yet on this basis alone, they will not be denied a remedy under the 1933 and 1934 Acts.[102]

C. Alternate Approaches

There has recently been some interest in establishing a uniform test for defining all security transactions.[103] In the area of business purchases through stock transfers, two approaches in particular have been advanced which support the view that federal securities regulations are inapplicable to such purchases. First, it has been suggested that the standard for finding the existence of an investment contract provides a meaningful definition for security transactions in general.[104] It is argued that this approach characterizes all investment schemes intended to be included within the generic term security.[105] A second approach has attempted to distinguish between transactions which are for investment purposes and those which are of a purely commercial nature[106]—in the former case, the federal securities laws

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[100] The two major benefits of employing a stock transfer would be the avoidance of the tax recapture provisions and the flow through of the selling corporation's accumulated tax preference benefits.

[101] *See* Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. at 336.

[102] No case has ever held that a subjective reliance on federal securities law coverage must be shown as a pre-condition to recovery.

[103] *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971); Comment, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation*, 8 FLA. ST. L. REV. 295 (1980).

[104] *E.g.*, Coffin v. Tricoli, 470 F. Supp. 7, 10 (E.D. Va. 1977); Comment, *supra* note 103, at 309-10. *See* Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 496 F.2d 1255, 1261 (4th Cir. 1974) (defendant argued that every security must meet the definition of an investment contract).

[105] Comment, *supra* note 103, at 310-11. *See* Dueker v. Turner, [1980] FED. SEC. L. REP. (CCH) ¶97,386, at 97,536 (N.D. Ga. 1979); Coffin v. Tricoli, 470 F. Supp. 7, 10 (E.D. Va. 1977).

[106] *E.g.*, Fredericksen v. Poloway, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,815, at 90,073. *See* C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973).

would have jurisdiction, in the latter, other laws would govern. While these two approaches may have merit in other contexts, they should not be decisive where corporate stock is concerned.

As previously discussed, the Supreme Court in *Howey* held that an investment contract exists if there is "an investment of money in a common enterprise with profits to come solely from the efforts of others." [107] This formulation, however, has been modified slightly by lower federal courts.[108] In particular, the investor is permitted a certain degree of managerial control over his investment without it losing its status as an investment contract.[109] Thus, an investor is not denied protection of the securities laws merely because the expected profits do not come "solely from the efforts of others." Instead, a more "realistic" approach has been adopted by at least three circuits.[110] The Court of Appeals for the Ninth Circuit, for example, has established a test whereby a security is present provided "the efforts made by those other than the investor are the undeniably significant ones," [111] with the investor involved in only a minor way.

It has been urged that either a strict or a modified version of the *Howey* test is in harmony with both the purposes of the securities laws and the Supreme Court's decisions defining the term security.[112] Yet, adoption of this approach as a general method of identifying when the

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[107] 328 U.S. at 301. *See* notes 33 & 34 *supra* and accompanying text.

[108] *E.g.*, SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). *See* Newton, *supra* note 7, at 192-98.

[109] *E.g.*, SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

[110] SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974); Nash & Assocs., Inc. v. Lum's of Ohio, Inc., 484 F.2d 392, 395 (6th Cir. 1973); SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

The Supreme Court also seems to have suggested that strict adherence to the literal language of the *Howey* test is not absolutely necessary, though the Court has not formally adopted an alternate approach. In *Forman*, 421 U.S. 837, after reiterating the *Howey* formula, the Court stated that "[t]he touchstone is 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." *Id.* at 852. Omitted from this version is the word "solely".

One of the most noteworthy departures from *Howey* was suggested by the California Supreme Court in Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). Known as the "risk capital" test, this approach expanded the concept of security by including instances where investors' funds are used as the initial capital needed to commence the potentially profitable project. Furthermore, under a risk capital analysis, it is not necessary to demonstrate that investors have the prospect for monetary returns; other types of benefit may suffice. Thus, in *Sobieski* investors only sought the benefits of membership in a country club when they placed their money in the hands of promoters. *Id.* at 812-13, 361 P.2d at 907, 13 Cal. Rptr. at 187.

[111] SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

[112] *See* note 105 *supra*.

sale of stock is a security transaction poses significant problems that cannot be overlooked.[113]

Under *Howey*, profits from an investment must be derived "solely from the efforts of others." [114] As such, this test operates to exclude from the protections of the securities laws all shareholders performing a managerial function within the operation of the issuing company.[115] Even under the modified *Howey* formula, shareholders who contribute in a "significant" way toward the management of the enterprise would similarly be denied securities law coverage.[116] Furthermore, since control is a significant factor in this test, in each case purportedly involving a security, an extensive factual inquiry into the internal workings of the issuing company would be necessary. In addition to being burdensome on courts, the propriety of such an inquiry in each instance that a plaintiff alleges the involvement of a security is dubious. In fact, the notion that a court should "delve into the workings of a validly existing business corporation and the relationship of the shareholders, just to make the threshold determination of jurisdiction" has been explicitly rejected.[117]

More importantly, an analysis focusing on control may lead to "arbitrary" results.[118] One element to be examined in assessing control will surely be the amount of stock held by the individual claimant. At some point, a presumption of control will arise based on the relatively large amount of stock held by that individual. The percentage of total stock deemed to constitute control will most likely not be a uniform figure. Consequently, there is a great potential for arbitrary and disparate results.[119] A degree of predictability in the administra-

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[113] It should be noted that many courts have rejected altogether the notion that the *Howey* test is applicable in determining whether ordinary corporate stock is a security. *E.g.*, Coffin v. Polishing Mach., Inc., 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 449 (D. Colo. 1978); Bronstein v. Bronstein, 407 F. Supp. 925, 929 (E.D. Pa. 1976).

[114] 328 U.S. at 301.

[115] *See* Bronstein v. Bronstein, 407 F. Supp. 925, 931 (E.D. Pa. 1976).

[116] This approach could have some strange results. For example, all key corporate employees who purchase stock in that corporation would not be viewed as purchasers of securities.

[117] Bronstein v. Bronstein, 407 F. Supp. 925, 929 (E.D. Pa. 1976). The *Bronstein* court went on to note that "[s]uch an inquiry has been necessary only in rare cases such as *Forman*, when an instrument denominated as stock lacked the characteristics traditionally associated with stock." *Id.*

[118] Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 496 F.2d 1255, 1263 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974).

[119] The court in Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc., 496 F.2d 1255 (4th Cir.), *cert. denied*, 419 U.S. 1023 (1974), was very concerned with this possibility. In speaking of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), the court refused to accept the idea that the provision's application "depend[s] on whether the purchaser of stock buys a small interest . . . or all of the stock, of a corporation." 496 F.2d at 1263. The court found that "such a standard

tion of the securities laws would be lost where corporate stock is involved.[120]

The other suggested approach for identifying securities transactions is the so-called "commercial-investment" dichotomy.[121] This device has been employed most notably in cases determining when notes are securities.[122] It has also been proffered, however, as a rationale for excluding from the purview of the securities laws business acquisitions through stock purchases.[123] Proponents of this test argue that the 1933 and 1934 Acts were designed to protect investors, not parties to a purely face-to-face commercial transaction such as a loan evidenced by the borrower's promissory note.[124] This distinction is a valid one in many cases. There is no doubt that the securities laws were enacted with a primary focus on protecting investors.[125] A bank which in the normal conduct of its business lends money to a consumer for purposes of purchasing an automobile could hardly be viewed as an investor merely because it receives a promissory note in consideration for that loan.[126] As such, the securities laws should not govern this type of transaction.

While the commercial-investment dichotomy is viable in the context of a simple consumer financing agreement, the distinction between investments and commercial transactions becomes hazy where two business entities are involved.[127] For example, in *Exchange National Bank v. Touche Ross & Co.*,[128] a brokerage firm seeking to finance the expansion of its overseas operations sold three unsecured subordinated notes to a bank.[129] The reason for the bank's decision to purchase the notes was two-fold—a favorable interest rate on the notes and a desire to develop closer relations between the bank's Tel Aviv office and the brokerage firm's Israeli branch.[130]

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would be difficult to apply and create a capricious basis for dispensing the protection of section 10(b)." *Id.*

[120] *See* Comment, *supra* note 103, at 312.

[121] *See* Fredericksen v. Poloway, [1981 Transfer Binder] FED. SEC. L. REP. ¶97,815, at 90,073.

[122] *E.g.*, Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

[123] *See* Fredericksen v. Poloway [1981 Transfer Binder] FED. SEC. L. REP. ¶97,815, at 90,073. The defendants in Bronstein v. Bronstein, 407 F. Supp. 925 (E.D. Pa. 1976), argued by analogy to the note cases that the sale of part ownership of a close corporation was a commercial transaction not covered by the securities laws. *Id.* at 930.

[124] *E.g.*, Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1260 (9th Cir. 1976); Bronstein v. Bronstein, 407 F. Supp. 925, 930 (E.D. Pa. 1976).

[125] *See* Bronstein v. Bronstein, 407 F. Supp. 925, 930 (E.D. Pa. 1976).

[126] *E.g.*, Emisco Indus., Inc. v. Pro's, Inc., 543 F.2d 38 (7th Cir. 1976); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974).

[127] *See* Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).

[128] 544 F.2d 1126 (2d Cir. 1976).

[129] *Id.* at 1129.

[130] *Id.*

When the firm became insolvent, the bank brought suit against the accountants who had issued an opinion attesting to the accuracy of certain financial information pertaining to the brokerage house and filed with the Securities Exchange Commission.[131] It was alleged *inter alia* that the accountants violated anti-fraud provisions of the 1933 and 1934 Acts[132] by knowing, or having reason to know, of inaccuracies within the financial information and yet issuing an opinion stating all figures were correct under general accounting principles.[133]

The question before the Court of Appeals for the Second Circuit was a jurisdictional one: were the notes securities for purposes of the federal securities laws?[134] In support of their attempt to have the case dismissed, the defendants contended that the notes merely amounted to evidence of a commercial loan and were not purchased by the bank for investment purposes.[135]

After reviewing several cases which employed a commercial-investment analysis,[136] Judge Friendly refused to adopt the test finding the distinction too tenuous to provide any meaningful guidance.[137] Instead, the "best alternative" was to presume the notes were securities since they fit within the literal definition of a security and to place "the burden of showing 'that the context otherwise requires' " on the party asserting that the notes were not securities.[138]

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[131] *Id.* at 1128.

[132] *Id.* at 1127. Specifically, the plaintiff averred violations of § 17 of the 1933 Act, 15 U.S.C. § 77q (1976), § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1980). 544 F.2d at 1128.

[133] 544 F.2d at 1128.

[134] *Id.*

[135] *Id.* at 1130.

[136] *Id.* at 1133-36. Cases reviewed by the court included: Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (note given to bank in exchange for renewable line of credit not a security); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (promissory notes delivered to bank for loan used to purchase assets of business not securities); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) (promissory notes executed as part of purchase price of franchise agreement found not to be securities).

[137] 544 F.2d at 1136-37. Under the facts of *Touche Ross*, the Exchange National Bank of Chicago was apparently motivated by considerations of both an investment and a commercial nature. The promise of high interest as well as the prospect for advancing the business interests of its Tel Aviv office were investment considerations. On the other hand, the extension of a loan to Weiss, Voisin & Co., Inc. was not outside the scope of the bank's normal commercial operations. *See id.* at 1128-29.

[138] *Id.* at 1137-38. The court then went on to list six instances in which the context would require otherwise. These six examples were:

> [1] the note delivered in consumer financing, [2] the note secured by a mortgage on a home, [3] the short-term note secured by a lien on a small business or some of its assets, [4] the note evidencing a "character" loan to a bank customer, [5] short-term

It is clear from *Touche Ross* that there are problems with the commercial-investment dichotomy. Outside the simple case of a consumer loan, the distinction between commercial and investment transactions becomes murky. Given that this test has not been enthusiastically endorsed as a workable standard in note cases, it is difficult to argue that such an approach should be adopted in cases involving stock transactions. For in that context, the distinction is no more clear.[139] There is, however, an additional consideration which militates against the use of the commercial-investment standard. The test was developed to determine when *notes* are securities, not when instruments labelled stock are securities. Much of the test's value is derived from the inherent dual character of notes—a character not present in stock. Notes are normally held by the lender as evidence of a loan. On the other hand, they are often procured for investment purposes as is usually the case in corporate debt offerings. By contrast, the purchase of common stock represents the purchase of ownership in the issuing company. While stock offerings can be a capital-raising device, the proceeds collected by the issuer are not on loan from the shareholder. There are no interest terms or repayment schedules; rather, the stockholder makes money on his purchase by receiving dividends or re-selling his ownership interest at an appreciated value.

In the case of close corporations, stock is acquired "for the purpose of acquiring an interest in a profit-making venture,"[140] not for

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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 (particularly if, as in the case of the customer of a broker, it is collateralized).

Id. at 1138.

In accord with the presumptive approach of *Touche Ross* is the recent Third Circuit case, Weaver v. Marine Bank, 637 F.2d 157 (3d Cir. 1980). At issue in *Weaver* was whether an agreement of guaranty whereby a bank loan to a third party was secured by the guarantor's pledge of a certificate of deposit in exchange for a 50% participation in earnings generated by the borrower's business, constituted a security transaction. *Id.* Reversing the district court's granting of defendant's summary judgment motion, Judge Gibbons determined that a trier of fact could conclude that the transaction amounted to either an investment contract or a certificate of interest or participation in a profit-sharing agreement. *Id.* at 161. *See* 15 U.S.C. § 78c(a)(10) (1976). More importantly, at the end of the opinion, Judge Gibbons stated that federal courts "ought to interpret the 1934 Act with a *presumption of coverage* of any transaction which Congress did not expressly exclude." 637 F.2d at 165 (emphasis added).

[139] Indeed, the decision to purchase a large block of stock in a company may be based on both commercial and investment considerations. For example, a manufacturing company may acquire stock in a supply company in order to assure itself some influence in the granting of supply contracts. By the same token, however, the stock purchase may have been motivated by the prospect of high dividends and appreciation in the stock's value. *Cf.* Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, *rehearing denied*, 350 U.S. 943 (1955) (sale of commodity futures held to be ordinary income rather than capital gains since futures contracts played important role in taxpayer's business).

[140] Bronstein v. Bronstein, 407 F. Supp. 925, 930 (E.D. Pa. 1976).

the purpose of making a commercial loan. The commercial-investment dichotomy is not inherently present,[141] and thus not a viable test for determining whether a given stock transaction is a security within the purview of the Acts.

CONCLUSION

Mifflin and *Fredericksen* demonstrate that despite the Supreme Court's decision in *Forman*, the question of when stock is to be considered a security is not totally resolved. There is presently a need for a uniform approach as to whether the sale of a business through a stock acquisition is within the scope of the securities laws. As it currently stands, the availability of protections contained within the 1933 and 1934 Acts will depend upon the jurisdiction in which the action is brought.

This comment has illuminated the problems inherent within the arguments disfavoring securities law jurisdiction. At the same time it has demonstrated that a finding of securities law coverage is both logical and in harmony with *Forman* and the remedial objectives underlying the 1933 and 1934 Acts.

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[141] An examination of who provides the "impetus" for the transaction may help determine whether it is of a commercial or investment nature. Thus, in C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, *cert. denied*, 423 U.S. 825 (7th Cir. 1975), the Court of Appeals for the Seventh Circuit noted that "buying shares of . . . common stock . . . where the impetus for the transaction comes from the person, is an investment; borrowing money from a bank . . . where the impetus for the transaction comes from the person who needs the money, is a loan." *Id.* at 1359.