

Is Stock a Security? A Criticism of the Sale of Business Doctrine in Securities Fraud Litigation

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INTRODUCTION

Notwithstanding the statutory definitions of a security,¹ all of which

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¹ The term "security" is defined in § 2(1) of the Securities Act of 1933 (Securities Act) as:

[A]ny 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 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.

15 U.S.C. § 77b(1) (1976). "Security" is defined in § 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act) as:

[A]ny 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). Both definitions are preceded by the introductory phrase, "unless the context otherwise requires."

Despite differences in the statutory language, it is accepted that the provisions should be construed equivalently. *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967).

expressly include stock, a majority of the courts recently considering the question have held that, in many instances, the sale of shares in closely held corporations² is not a sale of securities for the purpose of asserting private claims under the federal securities laws.³ Both federal and state

Thirty-four states, the District of Columbia and Puerto Rico have adopted substantially the Uniform Securities Act. The Act defines a "security" as:

[A]ny note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed number of dollars either in a lump sum or periodically for life or for some other specified period.

UNIF. SEC. ACT § 401(I), 7A U.L.A. 628 (1978).

There has been considerable cross-pollination between the state and the federal definitions both in drafting the statutes and in interpreting them. *Id.*, Commissioners' note at 631.

² Closely held, or close, or closed corporations, often referred to as incorporated partnerships, have no precise definition. For a legislative attempt, see DEL. CODE ANN. tit. 8, § 342 (1974). The principal characteristics of close corporations are generally thought to include: a small number of stockholders, no ready market for the stock, and substantial majority stockholder participation in the management, direction, and operations of the corporation. *See, e.g., Donahue v. Rodd Electrotape Co.*, 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1975).

³ The principal federal regulatory provisions are § 5 of the Securities Act, requiring registration of securities offered to the public, § 17(a) of the Securities Act, prohibiting fraud in the offer and sale of securities, and § 10(b) of the Exchange Act, and Rule 10b-5 thereunder, prohibiting fraud in the purchase and sale of securities.

Typically, initial issuances of securities in closely held corporations would be exempt from the § 5 registration requirements as "transactions by an issuer not involving any public offering," under 15 U.S.C. § 77d(2) (1976). Subsequent transfers would be exempt from registration as transactions not involving an underwriter, pursuant to 15 U.S.C. § 77d(1) (1976). *But see Swenson v. Engelstad*, 626 F.2d 421 (5th Cir. 1980) (sale of hockey team's stock to its coach and his wife not exempt from registration); *Lawler v. Gilliam*, 569 F.2d 1283 (4th Cir. 1978) (sale of two unique notes to one investor not exempt from registration). Securities transactions which are exempt from registration under Securities Act, § 4, 15 U.S.C. § 77d (1976), are not exempted from the antifraud provisions of either the Securities or the Exchange Act. Securities Act, § 17(a), 15 U.S.C. § 77q(a) (1976); Exchange Act, § 10(b), 15 U.S.C. § 78j(b) (1976). Thus, subject matter jurisdiction to consider claims under those provisions does not depend on registration but does depend, *inter alia*, on whether the transaction involves

the offer, purchase, or sale of a security.

Section 10(b) of the Exchange Act states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976). Rule 10b-5, promulgated by the Securities and Exchange Commission (SEC) in 1942, states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any persons, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1982). Federal courts have consistently implied a private cause of action under Rule 10b-5, beginning with *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court first acknowledged existence of a private claim in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

Section 17(a) of the Securities Act states that:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976). The Supreme Court has not decided whether there is a private right of action implied under § 17(a). The circuit courts of appeals are split on this issue. The most recent and comprehensive analysis is found in *Landry v. All American Assur. Co.*, 688 F.2d 381 (5th Cir. 1982). The Fifth Circuit held, based on Supreme Court precedent, that no private claim should be implied. The court acknowledged that its holding was a minority view, but noted that few courts had analyzed the issue in depth. *Accord Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 159 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978). *Contra Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981); *Lincoln Nat'l Bank v. Heber*, 604 F.2d 1038, 1039 (7th Cir. 1979); *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir.

courts⁴ have so concluded, principally based on their analysis of the

1978), *cert. denied*, 442 U.S. 909 (1979); *Newman v. Prior*, 518 F.2d 97, 98 (4th Cir. 1975) (private right of action exists). *See generally* Scholl & Perkowski, *An Implied Right of Action Under Section 17(a): The Supreme Court Has Said "No," But Is Anybody Listening?*, 36 U. MIAMI L. REV. 41 (1981).

While it appears unlikely that the Supreme Court will infer additional private rights of action from the texts of the securities laws, *see* note 10 and accompanying text *infra*, most complaints which include a § 17(a) claim also state a Rule 10b-5 claim and the issue therefore is largely academic. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1969) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). Many courts, finding that the plaintiff has a claim under Rule 10b-5, do not reach the question of an implied remedy under § 17(a). *See, e.g., Wachovia Bank & Trust Co. v. National Student Mktg., Inc.*, 650 F.2d 342, 350 n.19 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981).

The Supreme Court recently decided that an implied remedy exists under Rule 10b-5 for purchasers who have an express remedy under § 11 of the Securities Act, 15 U.S.C. § 77k (1976), because the purchased securities were issued pursuant to a registration statement filed under § 5 of the Securities Act, 15 U.S.C. § 77e (1976). *Herman & MacLean v. Huddleston*, 103 S. Ct. 683 (1983).

State securities regulatory schemes vary. As of 1976, 45 jurisdictions required registration of securities or required selling broker-dealers to file information on securities. *See generally* L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 39 (1976). For the variety of antifraud provisions, *see id.* at 6-8. Discussion of the effect of the sale of business doctrine on state securities laws is outside the scope of this Article.

⁴ *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), discussed in notes 61-65 and accompanying text *infra*; *Kaye v. Pawnee Constr. Co.*, 680 F.2d 1360 (11th Cir. 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981), discussed in notes 51-58 and accompanying text *infra*; *Chandler v. Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977); *Goodman v. DeAzoulay*, No. 81-2550 (E.D. Pa. Jan. 11, 1983) (available on LEXIS, Fedsec library, Courts file); *C.P. Corp. v. Life Investors, Inc.*, No. 80-C-2476 (N.D. Ill. Dec. 15, 1982;) (available on LEXIS, Fedsec library, Courts file); *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982); *Kane v. Fischbach*, [Current Developments] FED. SEC. L. REP. (CCH) ¶ 98,608 (E.D.N.Y. Mar. 31, 1982); *Kasch Enter. v. Soren*, No. 79-C-2661 (N.D. Ill. Dec. 14, 1981) (available on LEXIS, Fedsec library, Courts file); *Libco Corp. v. Dusek*, No. 77-C-4386 (N.D. Ill. Oct. 16, 1981) (available on LEXIS, Fedsec library, Courts file); *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257 (S.D.N.Y. 1981); *Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981); *Ellis v. Henderson*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,722 (W.D. Okla. Oct. 24, 1980); *Dueker v. Turner*, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977); *Howard v. Chrysler Corp.*, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,306 (D. Colo. Aug. 1, 1977); *Fox v. Ehrmantraut*, 28 Cal. 3d 127, 615 P.2d 1383, 167 Cal. Rptr. 595 (1980); *Tech Resources, Inc. v. Estate of*

United States Supreme Court's decision in *United Housing Foundation, Inc. v. Forman*.⁵

The conclusion that stock is not a security not only ignores the literal meaning of the federal securities statutes, but also marks a drastic departure from the views generally accepted prior to *Forman*. Until *Forman* it was well established that transfers of stock in closely held corporations were transactions involving securities and, as such, were subject to federal securities laws.⁶ Indeed, *Kardon v. National Gypsum Co.*,⁷ the first case to imply a private cause of action under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 of the Securities and Exchange Commission (SEC), involved the buyout of a fifty percent shareholder group in a close corporation by the other fifty percent shareholder group.

Courts occasionally expressed discomfort with this view,⁸ but it was not until the Seventh Circuit's 1981 decision in *Frederiksen v. Poloway*⁹ that it became widely accepted that transfers of stock in

Hubbard, 246 Ga. 583, 272 S.E.2d 314 (1980); *Kaiser v. Olson*, 105 Ill. App. 3d 1008, 435 N.E.2d 113 (1982).

Other courts have either rejected the sale of business doctrine outright or questioned its validity. See *Cole v. PPG Indus.*, 680 F.2d 549 (8th Cir. 1982) (applying Arkansas law); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982), discussed in notes 66-77 and accompanying text *infra*; *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), discussed in notes 78-83 and accompanying text *infra*; *Occidental Life Ins. Co. v. Pat Ryan & Assocs., Inc.*, 496 F.2d 1255 (4th Cir. 1974) (pre-*Forman*); *Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 48 (E.D. Mich. 1982); *Sterling Recreation Org. v. Segal*, 537 F. Supp. 1024 (D. Colo. 1982); *Alna Capital Assocs., Inc. v. Wagner*, 532 F. Supp. 591 (S.D. Fla. 1982); *Mifflin Energy Sources, Inc. v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

⁵ 421 U.S. 837 (1975).

⁶ See, e.g., *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960); *cert. denied*, 365 U.S. 870 (1961); *Errion v. Carroll*, 236 F.2d 447 (9th Cir. 1956); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953).

⁷ 69 F. Supp. 512 (E.D. Pa. 1946).

⁸ See, e.g., *Glick v. Campagna*, 613 F.2d 31, 35 n.3 (3d Cir. 1979) (although not wholly persuaded that regulation of close corporations was intended by Congress, court felt bound by literal reading of statute and governing precedent); *Chiodo v. General Waterworks Corp.*, 380 F.2d 860, 863-64 (10th Cir.), *cert. denied*, 389 U.S. 1004 (1967) (court questioned application of securities laws to sale of business, but dismissed case because of expired statute of limitations); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543-44 (N.D. Ill. 1970) (court considered sale of business doctrine, but rejected it); see also 1 L. LOSS, SECURITIES REGULATION 458-60 (1961); 4 L. LOSS, SECURITIES REGULATION 2489-91 (1969).

⁹ 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). The widespread

closely held corporations were, under the sale of business doctrine, not subject to federal securities laws.

The issue of whether stock is a security typically involves the sale of all the corporate stock of an active, closely held business to an individual or corporation that takes over the operation of the business. The disappointed purchaser may subsequently bring an action under Section 10(b) and Rule 10b-5 of the Exchange Act, alleging fraudulent statements or omissions in connection with the sale of the stock. Courts that have adopted the sale of business doctrine have reasoned that, since the plaintiff purchased an ongoing business and took over its operation, the transaction did not involve an investment decision and was not a securities transaction. The purchasers' suits are thus dismissed for lack of federal subject matter jurisdiction. Lower federal courts apparently are striving to expand upon the Supreme Court's dual policies of denying relief to many securities plaintiffs¹⁰ and, toward that end, of devis-

acceptance of the sale of business doctrine is discussed in part II *infra*.

Commentary generally approves of the sale of business doctrine. See Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Securities Transaction*, 57 N.Y.U. L. REV. 225 (1982); Note, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulations*, 8 FLA. ST. U. L. REV. 295 (1980); Note, *Securities Regulation — Is Stock a Security?*, 30 KAN. L. REV. 117 (1981); Comment, *The Sale of a Close Corporation Through a Stock Transfer: Covered by the Federal Securities Laws?*, 11 SETON HALL L. REV. 749 (1981). But see Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99 (1982).

Mr. Seldin approves of the doctrine because it enhances the attractiveness of a stock transaction by providing relief from the burdens of federal securities regulation. Seldin, *supra*, at 637. Professor Thompson argues that there are distinctions between state and federal fraud and that Congress intended the securities laws to reach only those transactions in need of special federal protection. Federal protection is needed only when the purchaser becomes a passive investor in an enterprise. Thompson, *supra*, at 242-44. In contrast, Professor Dillport asserts that Congress deliberately drafted an overinclusive definition of security to provide protection against fraud. Dillport, *supra*, at 122-28.

¹⁰ The Supreme Court's effort to reduce the number of securities cases in federal courts is manifested by decisions in three substantive areas of securities law. First, the Supreme Court has narrowed the scope of federal securities jurisdiction by finding that certain types of instruments, e.g., stock in housing cooperatives, employees' pension plans, certificates of deposit in federally regulated banks, are not "securities." See notes 20-37 and accompanying text *infra*. Second, the Court has narrowed the reach of Rule 10b-5 by holding that: (a) the plaintiff must be a purchaser or a seller of securities, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); (b) the defendant must have acted with scienter, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); (c) the misconduct must involve deception or manipulation, *Santa Fe Indus., Inc. v. Green*,

ing rules to weed out at early stages of litigation, plaintiffs who do not assert what the courts feel sure will turn out to be meritorious Rule 10b-5 claims.

This Article criticizes the use of the sale of business doctrine in securities fraud litigation. The Article first discusses the Supreme Court's efforts at defining a security, from its early investment contract analysis in *SEC v. W.J. Howey Co.*,¹¹ to *Forman* and other recent opinions. Part II analyzes the leading federal cases on the sale of business doctrine and examines problems in applying the doctrine. Next, part III examines alternative bases, within established Rule 10b-5 jurisprudence, for dismissing the claims of purchasers of stock in close corporations. Finally, the Article asserts that, because the sale of business doctrine is inconsistent with congressional intent and is an improper solution to problems that exist in Rule 10b-5 practice, it should be re-

430 U.S. 462 (1977); and (d) when the alleged misconduct involves nondisclosure, the defendant must have had a duty to disclose, *Chiarella v. United States*, 445 U.S. 222 (1980). Third, the Court has reduced the number of private suits that can be brought by refusing to imply additional private causes of action. Compare *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) and *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), with *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979), *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), and *Piper v. Chris-Craft Indus., Inc.* 430 U.S. 1 (1977).

In narrowing the scope of Rule 10b-5, the Court has relied on the following policy considerations:

1. "[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739. This may give even the flimsiest case a substantial settlement value. *Id.* at 740.
2. The Court is reluctant to create a federal claim when it is "unnecessary to ensure the fulfillment of Congress' purposes," *Santa Fe Indus.*, 430 U.S. at 477; when it would serve "at best a subsidiary purpose" of the federal legislation, *id.* at 478, or when the cause of action is one "traditionally relegated to state law" *Id.* "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.* at 479. Finally, in the area of implying federal causes of action under the securities laws, the Court has moved away from its early willingness to imply causes of action, to an unwillingness to do so without arguably clear congressional intent to create a private federal claim. See, e.g., *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 24 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979). For a recent and rare implication of a private remedy in a federal statutory scheme, see *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 102 S. Ct. 1825 (1982) (private party may maintain action for damages caused by violation of Commodity Exchange Act). See generally Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553 (1981).

¹¹ 328 U.S. 293 (1946).

jected by the courts.

I. THE SUPREME COURT DECISIONS: INVESTMENT CONTRACTS AND ECONOMIC REALITIES

The United States Supreme Court has analyzed the definition of a security eight times since 1943.¹² In *SEC v. W.J. Howey Co.*,¹³ the Court enunciated the investment contract test for defining a security. It used the statutory phrase "investment contract" to *expand* the definition of security to include unconventional instruments not within the traditional types of securities expressly enumerated in the Securities Act of 1933 (Securities Act) or the Exchange Act. In *United Housing Foundation, Inc. v. Forman*,¹⁴ the Court emphasized that "economic realities" must be examined and applied in connection with the *Howey* investment contract test, and *narrowed* the definition of security to exclude an instrument denominated stock, notwithstanding the express inclusion of stock in the statutory definitions. The Court has continued to constrict the definition in its most recent decisions in this area, *International Brotherhood of Teamsters v. Daniel*¹⁵ and *Marine Bank v. Weaver*.¹⁶

A. SEC v. Howey: *The Investment Contract Test*

In *Howey*, the SEC sought to enjoin defendants from offering and selling unregistered securities in violation of Section 5 of the Securities Act.¹⁷ Defendants offered vacationers in Florida a strip of a citrus grove along with a service contract for the cultivation and marketing of the fruit. The district court found, and the appeals court agreed, that there was no security involved, because the purchase of land and the arrangement of services were two separate transactions.

The Supreme Court reversed, finding that these transactions constituted an "investment contract," one form of security in the Securities

¹² Chronologically, the eight cases are: *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979); *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

¹³ 328 U.S. 293 (1946).

¹⁴ 421 U.S. 837 (1975).

¹⁵ 439 U.S. 551 (1979).

¹⁶ 455 U.S. 551 (1982).

¹⁷ 15 U.S.C. § 77e(c) (1976); see note 3 *supra*.

Act. The Court noted that the purchasers were vacationing business and professional people who were told that investment in a grove was not feasible unless service arrangements were made. The service contract had a binding term of ten years and gave the owners no right to enter their land to pick fruit without the company's consent. In addition, the owners had no right to specific fruit, and were entitled only to allocable portions of the net profits from the entire grove.¹⁸ The Court focused on the sales pitch and the audience at which it was directed, and found that an investment contract existed because the plan constituted "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party."¹⁹

B. United Housing Foundation, Inc. v. Forman: The Economic Realities Approach

Plaintiffs in *Forman* lived in a state subsidized, nonprofit housing cooperative. They brought a class and derivative action against the developers of the cooperative and others, alleging violations of Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. The Supreme Court held that shares of stock which entitled the purchaser to lease an apartment in the cooperative were not securities. The Court rejected the view that, because the shares were labelled stock, they must be considered securities because the statutory definition includes "any stock."²⁰ Instead, the Court determined that Congress intended not a literal approach,²¹ but an examination of the "economic realities."²² The Court did suggest that the literal approach

¹⁸ SEC v. W.J. Howey Co., 328 U.S. 293, 296 (1946).

¹⁹ *Id.* at 299.

²⁰ See note 1 *supra*.

²¹ The Court stated:

The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interests of investors. 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.

United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975).

²² The "economic realities" approach was not new, as the Court noted. It originated in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), the first Supreme Court opinion to consider the definitional issue, and runs through *SEC v. W.J. Howey Co.*,

might be appropriate in certain cases to prevent disappointment of a purchaser's reasonable expectation that the federal securities laws were applicable:

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.²³

The Court believed, however, that the purchasers of the cooperative's stock could not have been so misled. First, they were purchasing stock to acquire a place to live; second, their stock lacked the characteristics traditionally associated with stock, such as the right to dividends, the right to vote, negotiability, the ability to be pledged or hypothecated, and the potential for appreciation in value.²⁴

The Court also held that the shares were not securities included within the catch-all statutory language, "in general, any interest or instrument commonly known as a 'security.'"²⁵ The Court stated that the *Howey* investment contract test²⁶ "embodies the essential attributes that run through all of the Court's decisions defining a security."²⁷

328 U.S. 293 (1946), and *Tcherepnin v. Knight*, 389 U.S. 332 (1967). *Joiner* and *Tcherepnin*, however, both strongly suggest that the economic realities approach should not exclude from the definition of securities instruments explicitly enumerated as securities in the statute. Thus, in *Joiner*, the Court stated that "[i]nstruments may be included within any of these definitions, as [a] matter of law, if on their face they answer to the name or description." 320 U.S. at 351. The Court's approach remained consistent with that view in *Tcherepnin*, in which it said that an instrument denominated a stock certificate would be deemed a security at least so long as profits are distributable through dividends, 389 U.S. at 339. In *Forman*, on the other hand, the Court dismissed the above language as dicta and emphasized the theme of economic realities found in *Howey*, 328 U.S. at 298, and in *Tcherepnin*, 389 U.S. at 336. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849-50 (1975).

²³ 421 U.S. at 850-51.

²⁴ *Id.* at 851.

²⁵ See note 1 *supra*.

²⁶ See notes 17-19 and accompanying text *supra*.

²⁷ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). In contrast, the Court in *Tcherepnin* gave independent consideration and weight to each of the definitional terms used in the statute. The Court thus believed that the withdrawable savings and loan association capital shares could be considered as any one of the following: investment contract, certificate of interest or participation in any profit-sharing agreement, stock, or transferable share. *Tcherepnin v. Knight*, 389 U.S. 336, 339 (1967).

C. Post-Forman Opinions

Two Supreme Court opinions after *Forman* have likewise declined to view the definition of a security expansively. In *International Brotherhood of Teamsters v. Daniel*,²⁸ the Court held that an employee's interest in a noncontributory, compulsory pension plan was not a security for two reasons. First, the Court reiterated its earlier language narrowing the scope of Rule 10b-5: "The starting point in every case involving construction of a statute is the language itself,"²⁹ and noted that the definitions of security in both the Securities Act and the Exchange Act did not specifically include employee pension plans, despite their widespread use at the time the statutes were enacted.³⁰ The Court then focused on the *Howey/Forman* investment contract/economic realities test and found that there was no investment of money in a common enterprise and no expectation of profits from the efforts of others.³¹

²⁸ 439 U.S. 551 (1979).

²⁹ *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979). This sentence has appeared in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975).

³⁰ *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979). In Interpretative Release No. 33-6188, 1 FED. SEC. L. REP. (CCH) ¶ 1051 (Feb. 1, 1980) the SEC staff analyzed *Daniel* and determined that employee benefit plans which were both voluntary and contributory for participating employees were subject to the registration requirements and the antifraud provisions of the Securities Act. Registration, however, would in most instances be required, under the staff's interpretation of the Securities Act's § 3(a)(2) exemption, 15 U.S.C. § 77c(a)(2) (1976), only when the plan invests in the employer's own securities in an amount greater than that contributed to the plan by the employer. In Interpretative Release No. 33-6281, 1 FED. SEC. L. REP. ¶ 1052 (Jan. 15, 1981), the staff confirmed this view. Notwithstanding the SEC's view, lower courts have extended the *Daniel* rationale to exclude interests in voluntary and contributory plans from the definition of securities. *Coward v. Colgate-Palmolive Co.*, 686 F.2d 1230 (7th Cir. 1982); *Cunha v. Ward Foods, Inc.*, 545 F. Supp. 94 (D. Hawaii 1982); *O'Neil v. Marriott Corp.*, 538 F. Supp. 1026 (D. Md. 1982); *Tanuggi v. Grolier, Inc.* 471 F. Supp. 1209 (S.D.N.Y. 1979); *Newkirk v. General Elec. Co.*, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,216 (N.D. Cal. Aug. 31, 1979).

³¹ The plaintiff in *Daniel* had argued that part of his total employment compensation was invested in the fund. The Court found this insufficient to meet the *Howey* investment-of-money test. What *Howey* contemplated was a "specific consideration" given up in exchange for an interest that had the characteristics of a security. In contrast, the purported investment in *Daniel* was a relatively insignificant part of the employee's total and indivisible compensation package. Applying *Forman's* "economic realities," it was clear to the Court that plaintiff was working to earn his living, not to make an investment in the future. 439 U.S. at 560. Plaintiff also argued that he expected to receive profits upon retirement from the plan managers' skill in investing the

While the principal basis for the *Daniel* holding was thus a ringing affirmation of *Forman's* economic realities test, the Court in *Daniel* nevertheless employed two inconsistent methods of interpreting the statutory definition. The Court first examined the language of the statute and found that pension plans were not explicitly included. But then, quoting from *Howey*, it stated that the substance, or economic realities, of the transaction outweighed the import of the names given to the instruments.

In *Marine Bank v. Weaver*,³² the latest Supreme Court opinion on the definitional issue, plaintiffs purchased a certificate of deposit from defendant bank and subsequently pledged it to the bank to guarantee a loan made by the bank to a third party. The borrowers in turn agreed to give plaintiffs fifty percent of their business' net profits. The borrowers went bankrupt, and plaintiffs sued the bank under Section 10(b) and Rule 10b-5. The Court held that neither the conventional certificate of deposit from a federally regulated bank nor the agreement which gave plaintiffs fifty percent of the net profits of the borrowers' business was a security.

The Court found that the certificate of deposit was not a security principally because it was issued by a federally regulated bank.³³ The plaintiffs assumed virtually no risk of nonpayment, unlike holders of other forms of long-term debt instruments. Accordingly, the Court concluded, there is no need to include transactions involving these instru-

fund's assets. This argument failed on two grounds. First, under the Court's view, plaintiff's concept of "profit" was faulty, since it was based on his assertion that he had in fact contributed part of his compensation to the fund, with his ultimate receipt of more than he gave representing profit. The Court found that plaintiff made no identifiable contribution. Second, the Court found that the fund's dependence on earnings from its assets was not substantial because the bulk of the fund's income came from the participating employers' contributions. Accordingly, plaintiff's expectation of profits rested not on the managers' investment acumen, but on the continued increase in employers' contributions, over which the fund managers had no control. In this regard, the Court noted that the biggest risk to plaintiff's receipt of the benefits was not the fund's mismanagement of its assets, but his own inability to meet the fund's eligibility requirements. 439 U.S. at 562.

³² 455 U.S. 551 (1982).

³³ The Court made reference to its decision in *Daniel* and to the extensive federal regulation of pension plans by ERISA. *Marine Bank v. Weaver*, 455 U.S. at 558 n.7. The Court distinguished the certificate of deposit from the withdrawable capital shares of a savings and loan association found to be securities in *Tcherepnin v. Knight*, 389 U.S. 332 (1967). Because holders of the latter instruments received dividends based on the association's profits and had voting rights, the withdrawable capital shares were much more like "the ordinary concept of a security" than was the certificate of deposit. 455 U.S. at 557.

ments within the scope of transactions subject to securities regulation.

The Court's analysis of the agreement between the plaintiffs and the borrowers is more significant. The Third Circuit had emphasized that the agreement gave the plaintiffs a share of the profits in the borrowers' business and therefore embodied the elements of the classic *Howey* investment contract.³⁴ Without analyzing whether the *Howey* test had in fact been satisfied,³⁵ the Court determined that the profit-sharing arrangement was not sufficient to make the agreement a security. The agreement was not within the "ordinary concept of security"³⁶ because there were no offers made to a number of potential investors, and no instruments were created that could have been valued by the marketplace and traded publicly.³⁷ Instead, the agreement was a privately negotiated transaction, with unique features that made it an inappropriate instrument for trading. Accordingly, the Court found that it was not a security.

D. Conclusion and Forecast

Apparently, the Court is looking for one test to determine what is a security. Thus far, the Court's emphasis has been on the investment contract test of *Howey*.³⁸ It is equally apparent, however, that developing a single test has proved elusive.³⁹ The *Howey* test presents difficulties; *Forman* and *Daniel* make that clear. The failing of the *Howey*

³⁴ *Weaver v. Marine Bank*, 637 F.2d 157, 162 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982).

³⁵ The Court did, however, note that "the provision that the Weavers [plaintiffs] could veto further loans gave them a measure of control over the operation of the [business] not characteristic of a security." *Marine Bank v. Weaver*, 455 U.S. at 560. Many senior securities give the holder such forms of negative control over the issuer; yet their status as securities for purposes of federal securities regulation has not been questioned.

³⁶ *Id.*

³⁷ In *Tcherepnin v. Knight*, 389 U.S. 332 (1967), the Court stated that the ability to be traded in a marketplace is not a critical factor in determining the existence of a security. 389 U.S. at 343, 345. In *Weaver*, however, the Court emphasized the unique nature of the agreement, the private negotiations, and the agreement's inability to be traded publicly in finding that the profit-sharing agreement was not a security. 455 U.S. at 560. There is, of course, a distinction between the withdrawable capital share in *Tcherepnin* and the agreement in *Weaver*. In the former, it was certainly possible for a trading market to exist; indeed, such shares apparently were traded for a brief time on a regional stock exchange. 389 U.S. at 345 n.34. In *Weaver*, on the other hand, it is hard to imagine this sort of profit-splitting agreement being traded publicly.

³⁸ See notes 17-19 and accompanying text *supra*.

³⁹ See Schneider, *The Elusive Definition of a "Security,"* 14 REV. SEC. REG. 981 (1981).

investment contract test, in the view of the Court, is that it is potentially too inclusive.⁴⁰ Thus, the Court melded to it the economic realities approach of *Forman* and *Weaver*, which may be stated as, "in view of the economic realities, does it look, feel or smell like a security?"

Forman and *Weaver* set forth various factors of economic reality to be considered. First, securities generally have certain characteristics such as the ability to be negotiated, pledged, or hypothecated, and carry certain accoutrements, such as the rights to vote and receive dividends.⁴¹ Second, securities can be traded in the marketplace,⁴² and a correlative factor is the market's ability to fix an objectively ascertainable value to the instrument.⁴³ Third, if there is no other regulatory scheme that more appropriately provides coverage for transactions involving this instrument,⁴⁴ then the instrument is more likely to be a security.

The Court, however, may not be entirely comfortable with its pragmatic approach, which would eliminate from the definitional sections of

⁴⁰ Ironically, many commentators have criticized the *Howey* test as being too narrow. See, e.g., Carney & Fraser, *Defining a "Security": Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73 (1981); Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L. J. 219 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971). Some state courts have adopted a "risk capital" test to remedy one significant limitation of the investment contract approach: the requirement of profits. The classic exposition of the risk capital theory is Justice Traynor's opinion in *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), in which the sale of memberships to finance construction of a country club to be run for profit was found to contravene California's securities law. In analyzing the statute, Justice Traynor noted that its definition included noninterest bearing debt instruments and concluded that:

Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.

Id. at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89. The Supreme Court has not passed on the question of whether the risk capital test is to be used in federal courts, *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 857 n.24 (1975). See Comment, *The Federal Definition of a Security—An Examination of the "Investment Contract" Concept and the Propriety of a Risk Capital Analysis Under Federal Law*, 12 TEX. TECH. L. REV. 911 (1981).

⁴¹ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975).

⁴² *Marine Bank v. Weaver*, 455 U.S. 551, 560 (1982).

⁴³ *Id.*

⁴⁴ *Id.* n.7.

the statutes all words other than "investment contract." While the Court made clear in both *Forman* and *Weaver* that finding an instrument to be a security is not mandated merely by its inclusion among those expressly denominated securities in the Acts, the Court began its analysis in *Daniel* by noting that pension plans were not included in the statutory definition. In addition, strict adherence to a pragmatic approach here contrasts sharply with the Court's approach in other areas of securities law, in which the Court has significantly reduced the scope of regulation by substantial reliance on legislative intent as divined from the statutory language.⁴⁵

Looking only at these opinions, can one forecast the Court's response to the sale of business doctrine enunciated in *Frederiksen v. Poloway*? Under *Howey*, it is clear that stock held by the manager of the business, typically the sole shareholder in a close corporation, does not meet the *Howey* investment contract test. There is no common enterprise when all the stock is held by one person⁴⁶ and there is no expectation of

⁴⁵ See note 10 and text accompanying note 30 *supra*.

⁴⁶ Judicial examination of *Howey*'s common enterprise requirement has arisen principally in cases involving pyramid schemes and discretionary trading accounts. The issue has been whether horizontal commonality is required under the *Howey* test or whether vertical commonality suffices. The distinction can be illustrated by comparing an investor who buys into a mutual fund with an investor who opens a discretionary trading account with his broker. In the former case, the investor's contribution is pooled with other contributions and is jointly invested by the manager; his return is a pro rata share of the profits made by the manager on the pooled fund. His fortunes, therefore, are in common with all other investors in the mutual fund, and there is horizontal commonality. In the latter case, while the broker-dealer may manage numerous discretionary trading accounts, there is no commingling of the accounts. The fortunes of any individual investor remain separate from those of any other investor, and the common thread is supplied by the broker-dealer; hence vertical commonality. Compare *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa., 1972), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1973) (requiring horizontal commonality), with *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *Troyer v. Karcagi*, 476 F. Supp. 1142 (S.D.N.Y. 1979) (vertical commonality sufficient).

The Ninth Circuit has held that although vertical commonality can satisfy the common enterprise requirement, there is no common enterprise in a discretionary trading account unless there is some direct relation between the success or failure of the broker and that of the investor. Discretionary accounts therefore ordinarily will not be securities, since the broker will profit from his commissions even though the investor's account suffers losses. *Meyer v. Thomson & McKinnon Auchincloss Kohlmeyer, Inc.*, 686 F.2d 818 (9th Cir. 1982), *appeal filed*, 51 U.S.L.W. 3555 (U.S. Jan. 14, 1983) (No. 82-1195); *Mordaunt v. Incomco*, 686 F.2d 815 (9th Cir. 1982).

profits from the efforts of others, since the shareholder is managing the corporation. Thus, if the *Howey* test is the exclusive test, the Court will accept the sale of business doctrine, and hold that stock is not a security.

The *Forman* opinion is subject to two interpretations. On one hand, *Forman* supports a distinction between an interest in a corporation formed to engage in business, the most traditional form of stock, and shares in a housing cooperative, which are more commonly viewed as interests in real property. Moreover, corporate stock generally has all of the traditional characteristics associated with stock.⁴⁷ Accordingly, then, one might conclude that *Forman* dictates no further scrutiny and that only corporate stock is a security. On the other hand, *Forman* also seemed to say that the investment contract analysis is the exclusive test, and that even if corporate stock is commonly known as a security, it is not a security unless it meets the *Howey* investment contract test.⁴⁸

Daniel and *Weaver* support the view that stock in close corporations is a security. First, *Daniel* reintroduced examination of the statutory language. Second, *Daniel* and *Weaver* emphasized the existence of a comprehensive regulatory scheme for the instruments involved in those cases; there is no comparable federal regulation for transactions in stock in closely held corporations. Third, *Weaver's* emphasis on the ordinary concept of a security would also seem to militate against acceptance of the sale of business doctrine. Stock in closely held corporations does not present the obstacles to public trading posed by the profit-sharing agreement in *Weaver*. As one commentator has stated, such stock is "waiting in the wings of the markets":⁴⁹ the manager of the corporation can, at any time, make a public offering of his stock to bring in passive investors and create a public trading market for the stock. Thus, under *Daniel* and *Weaver* the Court might reject the sale of business doctrine.

Finally, if the Court has the ideal of a unitary test, the sale of business doctrine would be repugnant to that ideal. This is because it neces-

⁴⁷ Shareholders in close corporations often restrict by contract the right to trade and pledge their stock. Many close corporations also do not pay dividends on their common stock, but distribute cash to their shareholders as salaries. This is because dividends must be paid from the corporation's after-tax dollars and are taxed once again when received by shareholders, whereas salaries are deductible from the corporation's income and are taxed only once, when received by the employee. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.03 (4th ed. 1979).

⁴⁸ See text accompanying notes 25-27 *supra*.

⁴⁹ FitzGibbon, *What is a Security? — A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 918 (1980).

sarily results in an instrument being a security in some transactions, but not in others, depending upon whether the parties intended to transfer control of a closely held corporation.

II. THE SALE OF BUSINESS DOCTRINE

Most courts that have considered the sale of business doctrine⁵⁰ have adopted the broader ruling of *Forman* and held that stock in closely held corporations is not a security if the purchaser assumes control of the enterprise. The courts have read *Forman* to require application of the *Howey* investment contract test and, applying the test, have found that no security was involved in the transaction. Further, they have found that the economic realities are that the purchaser is acquiring a business, not investing in securities. In other words, it is a commercial transaction, not an investment.

A. Frederiksen v. Poloway

The leading case espousing the sale of business doctrine is *Frederiksen v. Poloway*.⁵¹ In *Frederiksen*, plaintiff purchased all the assets and stock of a close corporation.⁵² The seller sued in state court for breach

⁵⁰ There are also a number of recent cases which do not appear to have considered the question. *Swenson v. Engelstad*, 626 F.2d 421 (5th Cir. 1980) involved the sale of 65 (out of 75 outstanding) shares of a corporation owning a hockey team to the team's coach and his wife. The sale of business doctrine apparently was not raised by the parties. Although the court could have raised the issue on its own motion because the issue involved its own jurisdiction to hear the case under FED. R. CIV. P. 12(h)(3), it did not.

⁵¹ 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

The Tenth Circuit had earlier adopted the sale of business doctrine in *Chandler v. Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977), aff'g [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,965 (D. Colo. Dec. 4, 1975). The *Chandler* court held that the sale of all the stock of a corporation owning a liquor store was not a transaction involving a security. The agreement referred to the purchase of "'described business and personal property . . . called K.E.W. Inc. . . .'" and stated "'PRICE TO INCLUDE: 100% of the outstanding issued stock of K.E.W., . . .'" The court held that the plaintiff was, in substance, purchasing a liquor store and "incidentally, as an indicia of ownership," was receiving the stock. 691 F.2d at 444.

⁵² The transaction was structured as a purchase of the corporate assets for \$191,800, to be paid as follows: \$160,000 to be paid into an escrow account to be used to pay all existing debts of North Shore Marina, Inc. (NSM) and any unknown liabilities; the balance of \$31,800 was to be paid in equal monthly installments over a three-year period beginning one year from the signing of the agreement. In addition, defendant Poloway, the sole shareholder of NSM, sold 10% of the NSM stock to Emerald City Corp. (ECC) for \$10, and, for an additional \$10, transferred his remaining 90% inter-

of contract and fraud when his employment was terminated six months after the sale. Defendants in the state action sued in federal court, asserting federal securities violations and pendent state law claims. The district court dismissed the action, and the Seventh Circuit Court of Appeals affirmed, on the ground that the transaction did not involve a security.

The Seventh Circuit rejected the purchaser's argument for a literal reading of the statute, and focused on whether the transaction was primarily for commercial or for investment purposes.⁵³ The court found that the sale was a commercial transaction for two reasons. First, the sale did not raise capital for corporate expansion, and was not, in *Forman's* language, "the sale of securities to raise capital for profit-making purposes."⁵⁴ Rather, the sale of stock was used to vest the purchaser with ownership of the business, similar to the method by which the purchaser in *Forman* obtained living quarters. Accordingly, title to the

est to a voting trust controlled by plaintiff Frederiksen, the president of ECC. After all the debts of NSM were paid out of the escrow account or earlier at the option of ECC, NSM would pay off the balance of the funds to Poloway in redemption of his shares held in the voting trust. There was also an agreement providing that ECC would employ Poloway for five years at an annual salary of \$32,000, plus a consulting fee and a 20% sales commission, and a management agreement between ECC and NSM, giving ECC management authority over the marina. 631 F.2d at 1149.

⁵³ In *Forman*, the Court emphasized that the purchasers of the housing cooperative's stock were motivated by a desire to obtain low-cost housing, not a desire to make an investment, since the stock did not pay dividends and could not appreciate in value. *United Hous. Found., Inc. v. Forman*, 421 U.S. 834, 851 (1975). This same distinction between a commercial and an investment transaction has also been drawn in cases involving the question of whether notes are securities. See *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1131-38 (2d Cir. 1976) for an analysis of the various approaches taken by federal courts on this issue. Commentary on this subject includes Lipton & Katz, "Notes" Are Not Always Securities, 30 BUS. LAW. 763 (1975); Lipton & Katz, "Notes" Are (Are Not?) Always Securities: A Review, 29 BUS. LAW. 861 (1974); Sonnenschein, *Federal Securities Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567 (1980); Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972); Comment, *Commercial Notes and Definition of 'Security' Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973). The proposed Federal Securities Code excludes from the definition of securities notes issued in a "primarily mercantile or consumer, rather than investment, transaction not involving a distribution," 1 FED. SEC. CODE § 202(150)(B)(iii) (1980), which the reporter says is the "least imperfect solution to a troublesome problem." *Id.* § 202(200).

⁵⁴ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). On this basis the *Frederiksen* court distinguished *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), discussed in notes 78-83 and accompanying text *infra*.

stock was passed "incidentally as an indicia of ownership of the business assets,"⁵⁵ and the transaction was not a sale of securities.

Second, the court applied the investment contract test of *Forman*:

The 'economic reality' test for determining the existence of a security involves three elements: (1) an investment in a common venture; (2) premised on a reasonable expectation of profits; (3) to be derived from the entrepreneurial or managerial efforts of others.⁵⁶

The court found the first element of the test absent here because there was no sharing or pooling of funds in a common venture.⁵⁷ The court also found that defendant was no longer a participant in a joint venture after the transaction, notwithstanding his employment agreement to receive a sales commission and his ownership of ninety percent of the stock transferred to a voting trust controlled by plaintiff. More important, the third element of the *Forman* test was lacking because plaintiffs assumed management of the business and were not depending on defendant's efforts to make a profit. The court rejected the assertion that the employment agreement established plaintiffs' reliance on defendant's efforts, since as an employee defendant was not responsible for those "essential managerial decisions" . . . affecting the conduct of the business."⁵⁸ Indeed, the agreement specified that defendant was to

⁵⁵ *Frederiksen v. Poloway*, 637 F.2d 1147, 1151-52 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

⁵⁶ 637 F.2d at 1152. The court attributes the test to *Forman*, but as the *Forman* court noted, the test originated in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The difference in language from *Howey*, see text accompanying note 19 *supra*, is because of the uncertainty as to whether the profits are to be derived "solely" or only "principally" or "significantly" from the efforts of others. The Fifth Circuit in *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) followed the Ninth Circuit in *SEC v. Glenn W. Turner Enter.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973), by permitting some degree of investor participation in a non-essential part of the business. The *Koscot* court stated, quoting from *Glenn Turner*, that "the critical inquiry is 'whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'" *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d at 483; see also *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d Cir.), *cert. denied sub nom. Hecht v. SEC*, 103 S. Ct. 568 (1982); *Goodman v. Epstein*, 582 F.2d 388, 408 n.59 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 875, 877 (10th Cir. 1975); *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971).

⁵⁷ *Frederiksen v. Poloway*, 637 F.2d 1147, 1152 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981), quoting *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 101 (7th Cir. 1977); see note 46 and accompanying text *supra*.

⁵⁸ *Frederiksen v. Poloway*, 637 F.2d 1147, 1153 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981), quoting *SEC v. Glenn W. Turner Enter.*, 474 F.2d 476, 482 (9th Cir.),

operate under the policies established by the new owner. Accordingly, under the investment contract analysis, there was no security here.

B. Variations On a Theme: The Sale of Business Doctrine in the Circuit Courts

In *Canfield v. Rapp & Son, Inc.*,⁵⁹ the Seventh Circuit made it clear that the *Frederiksen* holding was not limited to purchases of corporate assets along with stock. The court extended the doctrine to an acquisition solely of all the corporation's stock. On the other hand, in *McGrath v. Zenith Radio Corp.*,⁶⁰ the Seventh Circuit distinguished *Frederiksen*. In *McGrath*, defendant purchased all of the stock from a number of shareholders, including plaintiff McGrath, a minority shareholder and officer of the corporation. Plaintiff alleged that defendant had made misrepresentations regarding plaintiff's continued employment which induced him to sell his stock and surrender a stock option. The court found that plaintiff was an investor in the company and the stock was therefore a security in his hands; the stock did not lose its status as a security merely because all the holders transferred their stock simultaneously.

In *Sutter v. Groen*,⁶¹ however, the Seventh Circuit reconsidered the sale of business doctrine and reaffirmed it.⁶² The court found additional support for the doctrine in *Weaver's* holding that the bank certificate of deposit was not a security because of the protection of the federal banking laws.⁶³ In the Seventh Circuit's view, the Supreme Court in *Weaver* had clearly rejected a literal approach in favor of a pragmatic one.⁶⁴ Furthermore, the court determined that the 1934 Congress, which en-

cert. denied, 414 U.S. 821 (1973); *see note 56 supra*.

⁵⁹ 654 F.2d 459 (7th Cir. 1981).

⁶⁰ 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

⁶¹ 687 F.2d 197 (7th Cir. 1982). Plaintiff owned 70% of the stock of Happy Radio, Inc. whose principal asset was a contract to purchase all the stock of Bret Broadcasting Corp. from defendants over a twelve-year period and to manage Bret. Plaintiff alleged that defendants overstated the corporation's earnings both to induce plaintiff to pay an inflated price for the stock and to induce plaintiff to buy his 70% interest in Happy Radio. The court stated that Happy Radio's purchase of all of the Bret stock fell squarely within the sale of business doctrine.

⁶² The court felt reconsideration was appropriate in light of *Marine Bank v. Weaver*, discussed in notes 32-37 and accompanying text *supra*, and *Golden v. Garafalo*, discussed in notes 66-77 and accompanying text *infra*.

⁶³ Apparently, the Seventh Circuit did not find relevant *Weaver's* analysis of the profit-sharing agreement, since it did not discuss this part of the *Weaver* opinion.

⁶⁴ The Seventh Circuit ignored the fact that some commercial instruments, though "notes," have not been considered securities even by courts following a literal approach.

acted the Exchange Act, intended by its use of the term "investor" to exclude from protection the entrepreneur or the manager of a business.⁶⁵

On the other hand, in *Golden v. Garafalo*,⁶⁶ the Second Circuit considered and rejected the sale of business doctrine. Plaintiffs purchased a ticket brokerage business from its sole shareholder. The lawyers for the parties determined that the transaction should take the form of a sale of all of the stock, because the corporation's lease on the business premises contained a nonassignment clause. Although the stock was placed in escrow as security for full payment of the purchase price, the parties understood that the new owners had complete control over the business.⁶⁷ The court conceded that the transaction was squarely within the sale of business doctrine if the doctrine were law in the Second Circuit,⁶⁸ and acknowledged that the doctrine was not unreasonable,⁶⁹ but nevertheless rejected it.

The court first discussed the doctrine's "inherent elusiveness as a legal concept,"⁷⁰ and noted that the doctrine requires an assessment of the purchaser's intentions. Moreover, the court stated that problems also arise in determining what constitutes a controlling block of stock. The court also noted that the doctrine had even been extended to hold that publicly traded stock might not be a security in certain circumstances.⁷¹ Publicly traded stock, of course, had been thought since passage of the Acts to be the quintessential security, subject not only to the antifraud provisions of the Acts, but also to their other regulatory provisions. The court felt that acceptance of the doctrine would only add to the difficulties of trial judges, requiring them to rule on subjective factual issues simply to determine their own jurisdiction.

In reviewing *Howey*, *Forman*, and *Weaver*, the court determined that the *Howey* investment contract test was applicable only for uncon-

⁶⁵ For this assertion the court relied principally on Berle and Means' 1932 work *THE MODERN CORPORATION AND PRIVATE PROPERTY*, "which made 'the separation of [passive stock] ownership and [active managerial] control' in the modern corporation . . . a rallying cry for reformers," and led to enactment of the federal securities laws. 687 F.2d at 201.

⁶⁶ 678 F.2d 1139 (2d Cir. 1982).

⁶⁷ *Id.* at 1147 (facts taken from dissenting opinion of Lumbard, J.)

⁶⁸ *Id.* at 1142. Indeed, the Second Circuit thought the doctrine, if it were good law at all, was more clearly applicable in *Golden* than in *Frederiksen*. *Id.* at 1145.

⁶⁹ *Id.* at 1140.

⁷⁰ *Id.* at 1145.

⁷¹ *Id.* at 1142.

ventional forms of securities,⁷² and the court accordingly decided to follow the literal approach.⁷³ Since the stock in *Golden* had all the conventional attributes of stock it was considered to be "stock" and therefore was within the definition of a security. To do otherwise would, in the court's view, conflict with the apparent congressional intent in listing such well-recognized instruments as stock, treasury stock, and voting trust certificates, as well as catch-all phrases like "investment contracts" designed to cover unorthodox forms of securities. Had Congress intended economic realities to be the sole test, the court reasoned, there would have been no purpose in specifying instruments with established characteristics.⁷⁴

Finally, the court noted that rejection of the sale of business doctrine would result in "a certain overbreadth in application,"⁷⁵ whereby courts would hear cases involving facts beyond "Congress' core concern [which] was protection of the individual investor trading in public markets for shares of firms about which information is available only through intermediaries."⁷⁶ However, the court recognized that overbreadth would exist even if the sale of business doctrine were adopted, since it is present whenever persons in control of a corporation negotiate in face-to-face transactions.⁷⁷

⁷² *Id.* at 1143. The court's analysis might be described as facile because the Supreme Court precedent can be read both to support or reject the sale of business doctrine; see text accompanying notes 17-49 *supra*.

⁷³ The Second Circuit has consistently advocated literalism, see *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976); *Forman v. Community Servs., Inc.*, 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom.* *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

⁷⁴ *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982).

⁷⁵ *Id.* at 1146.

⁷⁶ *Id.*

⁷⁷ The court stated:

So far as the anti-fraud policies of the Acts are concerned, the possibilities of fraud and the ability to protect oneself through contract are the same as to a 'passive' investor buying 30% of a corporation's shares from a sole shareholder or an 'active' purchaser taking 100% and expecting to manage it directly. So far as curing the overbreadth of the Act is concerned, therefore, the relevant distinction is between transactions in a public market for stock and negotiated transactions involving close corporations, whether or not they include transfers of control. We take it, however, that the Act was always understood to apply to transactions in shares of close as well as publicly held corporations and to negotiated as well as market sales and purchases of shares. . . . *Forman* provides us no reason to reexamine that understanding. If the Congress is dissatisfied with the present scope of the Acts, we trust it will act accordingly.

Prior to *Garafalo*, the only circuit which had read *Forman* narrowly and rejected the sale of business doctrine was the Fourth Circuit, in *Coffin v. Polishing Machines, Inc.*⁷⁸ The plaintiff purchased a one-half interest in defendant corporation and became an officer. Subsequently he discovered that the corporation's president had converted corporate assets to his own use, leaving the corporation insolvent. The district court relied on *Forman* and granted defendants' motion to dismiss because plaintiff was to contribute substantially to the management. The substance of the transaction was therefore the sale of a half-interest in a business, and not the sale of securities.

The Fourth Circuit reversed, reasoning that because the statutory definitions include stock as a security, there is a "strong presumption"⁷⁹ that the statutes apply when a transaction involves stock. Accordingly, the court stated that *Forman* required analysis of the *Howey* criteria only when the stock involved did not have the "significant characteristics typically associated with the named instrument."⁸⁰ Moreover, the court considered it irrelevant that the transaction could have been structured in some other form.⁸¹ The Fourth Circuit's holding in *Coffin*, however, may be limited because the stock was sold in order to finance expansion of the corporate business and, as the court noted, the transaction was a classic sale of securities to raise capital for profit-making purposes.⁸² The Seventh Circuit relies on this language to reconcile

Id. at 1146-47.

⁷⁸ 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

⁷⁹ 596 F.2d at 1204. It seems this presumption would be rebutted upon a showing that the instrument denominated "stock" had none, or merely a few, of the characteristics of the instruments commonly considered to be stock. See *Slevin v. Pedersen Assocs., Inc.*, 540 F. Supp. 437, 440 (S.D.N.Y. 1982). The court rejected the argument that the economic realities of an arrangement called an "investment contract" could not be examined after the Second Circuit's opinion in *Golden*: "A lizard with a sign around its neck reading 'dog' does not change the lizard into a Labrador retriever."

⁸⁰ "Absent some showing that ordinary corporate stocks are other than what they appear to be, we need not consider whether an investor will derive his profit partly from his own efforts." *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202, 1204 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

⁸¹ "The parties in this case chose to implement their plan for joint ownership by means of a stock transfer rather than a partnership agreement or a sale of assets. Having decided to deal in stock, they brought their transactions under the provisions of the federal securities statutes." *Id.*

⁸² "The transaction appears to be 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.'" *Id.*, quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

Coffin with its own decisions.⁸³

C. Problems in Application of the Doctrine

1. Must All the Stock Be Transferred?

Since the essence of the sale of business doctrine is economic realities, the courts agree that individual transactions must be examined to ascertain if a security was involved. This approach, from the point of view of its adherents, rejects simplistic literalism and focuses on the purpose of the transaction and the intentions of the parties.⁸⁴ According to its critics, however, the sale of business doctrine adds complexity and uncertainty to an already difficult area of law.⁸⁵

Most of the cases in which the doctrine has been applied involved the sale of all the stock of an ongoing business; the purchaser subsequently brought an action under Section 10(b) of the Exchange Act and Rule 10b-5, alleging fraudulent misstatements or omissions in the negotiations.⁸⁶ Even the proponents of the doctrine, however, acknowledge that a sale of all the stock is not always outside the scope of federal securities regulation.⁸⁷ For example, the Seventh Circuit refused to apply the doctrine in *McGrath* when the plaintiff was a minority shareholder who along with the other shareholders sold his stock on the basis of false statements made to him about his future in the business.⁸⁸ The court reasoned that plaintiff was realistically an investor in the business and that defendant did not immunize its fraud by purchasing all the stock simultaneously.⁸⁹ Nevertheless, had the purchaser of all the stock

⁸³ See *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147, 1151 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

⁸⁴ *Frederiksen v. Poloway*, 637 F.2d 1147, 1150-52 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

⁸⁵ *Golden v. Garafalo*, 678 F.2d 1139, 1145-46 (2d Cir. 1982).

⁸⁶ See *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

⁸⁷ *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982).

⁸⁸ *McGrath v. Zenith Radio Corp.*, 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

⁸⁹ 651 F.2d at 467-68 n.5. In contrast, when plaintiff intended to be a passive investor, but purchased a small percentage of the stock as part of a group, some of whose members took over the management of the corporation, a state court found that plaintiff did not purchase a security. (Alternatively, the court held that plaintiffs had waived their claims and were estopped to assert them because of delay.) *Kaiser v. Olson*, 105 Ill. App. 3d 1008, 435 N.E.2d 113 (1982). However, if there were no affiliations between the minority shareholders and the controlling shareholders, apart from the fact

in *McGrath* been the plaintiff, it is clear that his suit would have been dismissed. Thus, application of the sale of business doctrine may turn on which party to the transaction brings suit.

No case to date has involved the sale of all the stock from plaintiff to the defendant.⁹⁰ Suppose plaintiff's business depended on a contract from a third party, and defendant had advance knowledge that plaintiff's corporation would get the contract, but told plaintiff the contrary and then bought the corporation's stock at a bargain price. Does *Frederiksen* require dismissal of the suit?⁹¹ Or suppose plaintiff sold the business to defendant on the basis of defendant's representation that he would continue plaintiff's employment in the business. Should a result different from that in *McGrath* follow? The sale of business doctrine offers no clear answer to these questions. Because one may control a corporation with less than one hundred percent stock ownership, in some cases with less than even fifty percent, the doctrine may be applicable when plaintiff purchases less than all the stock from defendant.⁹²

that their stock was acquired simultaneously, a court might find that the minority shareholders purchased a security and the controlling shareholders did not. The SEC takes the position that individuals who agree to acquire stock at the same time in a private placement are members of a group for the purpose of the reporting requirements under § 13(d) of the Exchange Act, 15 U.S.C. § 78m(d)(3) (1976). 17 C.F.R. § 240.13d-5(b) (1982); see also notes 103-13 and accompanying text *infra*.

⁹⁰ Indeed, sellers of stock in closely held corporations have been more fortunate than purchasers in escaping application of the sale of business doctrine to bar their claims. See *McGrath v. Zenith Radio Corp.*, 651 F.2d 458 (7th Cir.), cert. denied, 454 U.S. 835 (1981); *Stacey v. Charles J. Rogers, Inc.*, 542 F. Supp. 48 (E.D. Mich. 1982); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976). The only case in which a seller's claim has been dismissed is *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981). The *Barsy* court felt strongly that the requisite jurisdictional connection with interstate commerce was tenuous. *Id.* at 955 n.4; see notes 139-41 and accompanying text *infra*.

Stacey involved the sale of stock by plaintiffs, eight shareholders in two corporations, back to the corporations (in effect, to the sole remaining shareholder). The shareholders were children of the deceased founder of both corporations. The court questioned whether the Sixth Circuit would adopt *Frederiksen v. Poloway*, but felt it need not reach the question because the facts brought the case within the *McGrath* exception to the doctrine, see note 60 and accompanying text *supra*, for simultaneous sales by minority shareholders of substantially all of the corporation's stock. Although the eight shareholders may have owned sufficient stock to control the corporation, the court apparently viewed them as passive investors. 542 F. Supp. at 50.

⁹¹ Cf. *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1980) (defendant liable under Rule 10b-5 for misrepresenting value of stock to plaintiff); *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.) (defendant liable under Rule 10b-5 for misrepresentations which induced plaintiff to sell stock at low price), cert. denied, 434 U.S. 911 (1977).

⁹² A clear example of this is *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981), in which plaintiff purchased substantially all, but not all, of the stock

In determining the applicability of the doctrine, courts must ascertain whether a controlling block of stock has been transferred, and the result, a jurisdictional holding, may differ as to sales of stock in the same corporation by different persons.

Determining control in different contexts has been a difficult issue for securities lawyers.⁹³ Control turns not only on the amount of stock an individual owns, but also on how the balance of the stock is held. One must also consider whatever arrangements, explicit or implicit, that may exist among the shareholders for voting the stock and managing the business.

In *Sutter v. Groen*,⁹⁴ the Seventh Circuit adopted a rebuttable presumption that an owner of more than fifty percent of a corporation's common stock was an entrepreneur and not an investor, and therefore is barred by the sale of business doctrine from bringing a securities fraud claim. Because the owner would be able ordinarily to elect at least a majority of the directors, he would be able to control all corpo-

of three corporations from the defendant and at the same time bought out the remaining shareholders, who were defendant's daughters and employees. The court applied the sale of business doctrine.

⁹³ Under the Securities Act, public offerings of securities made by controlling persons require registration if they are offered or sold through channels of interstate commerce or the mails, Securities Act §§ 2(11), 4(1), 5; 15 U.S.C. §§ 77b(11), 77d(1), 77(e) (1976). Public offerings made by noncontrolling persons, however, need not be registered, Securities Act § 4(1), 15 U.S.C. § 77d(1) (1976). "Control" is not defined in the statute, but is defined by the SEC as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise," 17 C.F.R. § 230.405(f) (1982). The House of Representatives Committee Report stated that the "concept of control herein involved is not a narrow one, depending upon a mathematical formula of 51 percent of voting power, but is broadly defined to permit the provisions of the Act to become effective wherever the fact of control actually exists." H.R. REP. NO. 85, 73d Cong., 1st Sess. 14 (1933). The SEC has consistently refused to give advice to anyone seeking guidance as to whether he is a "controlling person," because the answer involves factual questions which the staff is not in a position to resolve. SEC Interpretative Release No. 33-6253, 45 Fed. Reg. 72,644 (1980).

A defendant's argument, in a criminal case, that the term "control" was unconstitutionally vague and indefinite was rejected in *United States v. Wolfson*, 269 F. Supp. 621 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969). See generally 2 L. LOSS, SECURITIES REGULATION 770-783 (2d ed. 1961); 5 L. LOSS, SECURITIES REGULATION 2700-2708 (Supp. 1969).

The proposed Federal Securities Code establishes a rebuttable presumption that a person who owns, or has the power to vote more than 25 percent of the outstanding voting securities (or owns more than 25 percent of total equity if the company has no voting securities), controls the company. 1 FED. SEC. CODE § 202(29)(B) (1980).

⁹⁴ 687 F.2d 197 (7th Cir. 1982).

rate decisions other than those requiring approval by more than a majority vote of the shareholders.

The owner may argue that since the degree to which someone who owns fifty percent or less controls the corporation does depend on the distribution of the remaining shares, the party asserting the sale of business doctrine should have to establish that the shareholder controls the corporation. The *Sutter* court, however, specifically left the issue open for future consideration.⁹⁵

Transfers of fifty percent ownership have engendered diverse holdings as to the applicability of the sale of business doctrine. In *Coffin*, the Fourth Circuit rejected the doctrine when plaintiff purchased one-half of the stock.⁹⁶ In *Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*,⁹⁷ a derivative action charging various acts of alleged corporate mismanagement, the doctrine was applied when an individual purchased fifty percent of the stock from another shareholder on condition that the purchaser would resume control and management of the corporation.⁹⁸ However, in the same case, when one person purchased a note secured by fifty percent of the stock, there was a sale of a security,

⁹⁵ *Id.* at 203. One court refused to apply the doctrine to the sale of 38% of a publicly traded corporation, although it appears that court may reject the doctrine altogether. *Alna Capital Assocs., Inc. v. Wagner*, 532 F. Supp. 591, 602 (S.D. Fla. 1982): "The Court finds that the prohibition of fraudulent securities transactions must apply to large purchases as well as small purchases. Moreover, the limitation of the concept of a security advocated by the Defendant is contrary to common sense and normal expectations."

⁹⁶ *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). *Frederiksen* attempted to distinguish *Coffin* by pointing out that the funds derived from the sale of stock in *Coffin* were to be used for corporate expansion. *Frederiksen v. Poloway*, 637 F.2d 1147, 1151 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). The *Garafalo* court, on the other hand, found that the facts in *Coffin* closely resembled the conversion of a sole proprietorship into a partnership and looked less like a securities transaction than the transaction in *Frederiksen*. *Golden v. Garafalo*, 678 F.2d 1139, 1145 (2d Cir. 1982).

⁹⁷ 513 F. Supp. 885 (N.D. Ill. 1981).

⁹⁸ The court noted that in *Frederiksen v. Poloway*, 687 F.2d 1147, 1151 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981), the plaintiff was the person assuming control, while in *Oakhill*, the plaintiff was the corporation, but it saw no reason to distinguish *Frederiksen* on this basis: "[T]o do so would require a determination that the same transaction could be deemed as involving a security as to some of the parties thereto, but not to others. The court declines to find that *Fredriksen* (sic) was intended to spawn such anomalous results." *Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*, 513 F. Supp. 885, 890 (N.D. Ill. 1981). In fact, as *McGrath* and *Oakhill* itself (see text accompanying note 99 *infra*) illustrate, *Frederiksen* leads to precisely such anomalous results.

apparently because there was no evidence that this transaction was intended to confer responsibility for day-to-day operations on the purchaser.⁹⁹

Finally, when all the stock was sold to a third party, a district court applied the doctrine to dismiss a suit by the former fifty percent holder against the former forty-two percent shareholder, which alleged that defendant had received a better price for his stock than did plaintiff.¹⁰⁰ In contrast, another district court rejected the doctrine when plaintiff, a one-third shareholder, sued his brother, another one-third shareholder, alleging that his brother induced him to sell the stock to defendant for a price below market value.¹⁰¹ Although both plaintiff and defendant were officers and directors, defendant handled all financial matters and plaintiff relied on him.¹⁰²

2. Management of the Corporation: Actual, Joint, Delegated

The examination of control necessarily must be concerned not only with percentage of stock ownership, but also with the actual management of the corporation. The courts consistently find that a seller who continues to work for,¹⁰³ or signs a consulting agreement with the purchaser,¹⁰⁴ does not diminish the purchaser's control. This rule has been applied even when the former owner continues negotiations on a key government contract.¹⁰⁵ These findings seem correct, since it is apparent that the new owners have taken over the actual operation of the business and are merely calling on the former owners to achieve an orderly transition and thus maximize the purchased goodwill.

A closer case is *Frederiksen*,¹⁰⁶ in which the new owner appeared to be relying extensively on the efforts of the former owner in running the business. The seller in *Frederiksen* entered a five-year employment agreement to "assist, guide and give his expertise" in return for an

⁹⁹ In addition, the court found that the terms of the note providing for accelerated payment in the event Oakhill achieved a certain level of success, made the note an investment and not a commercial transaction. *Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*, 513 F. Supp. 885, 892 (N.D. Ill. 1981).

¹⁰⁰ *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981).

¹⁰¹ *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

¹⁰² *Id.* at 926.

¹⁰³ See *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981).

¹⁰⁴ See *Golden v. Garafalo*, 521 F. Supp. 350 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

¹⁰⁵ See *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981).

¹⁰⁶ *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

annual salary, a consulting fee, and a twenty percent commission. The commission agreement was similar to a profit-sharing arrangement, which brought the transaction closer to the classic understanding of a security. Nevertheless, the court noted that the contract provided that the seller had to perform within "goals, guidelines, directives, policies and procedures" set by the purchaser. Accordingly, the purchaser controlled the business.¹⁰⁷

Additional problems are created when it appears that there may be joint control. The best example of this is *Coffin*, in which there were two fifty percent stockholders, and one was president and the other was vice president. The Fourth Circuit rejected the doctrine.¹⁰⁸ *Kane v. Fischbach*¹⁰⁹ provides another illustration of possible joint control. Defendant, the sole shareholder, transferred 155 of his 200 shares to a partnership consisting of defendant and the two plaintiffs. The plaintiffs became the directors of the corporation, and one was president. Defendant, now a 22½ percent shareholder, was executive vice president. The district court applied the sale of business doctrine to dismiss the plaintiffs' suit.

Perhaps the most difficult problems arise when the purchaser is inexperienced or otherwise unwilling to run the business and delegates control to another. His reliance on the efforts of a third party, for purposes of the *Howey* test,¹¹⁰ should place him within the protected class of a purchaser of a security. However, because he retains ultimate, albeit theoretical, control by reason of his stock ownership, he may be within the boundaries of the sale of business doctrine. Courts have fol-

¹⁰⁷ The *Golden* court found the holding in *Frederiksen* to be a questionable application of the sale of business doctrine. *Golden v. Garafalo*, 678 F.2d 1139, 1145 (2d Cir. 1982). On the other hand, the Seventh Circuit's reasoning in *Frederiksen* is strengthened by the fact that the so-called essential employee was fired within a year. *Frederiksen v. Poloway*, 637 F.2d 1137, 1149 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). See also *Kasch Enter. v. Soren*, No. 79-C-2661 (N.D. Ill. Dec. 14, 1981) (available on LEXIS, Fedsec library, Courts file). In *Kasch*, defendants, the five former shareholders of Globe Corporation, exchanged their Globe stock for redeemable preferred stock of Kasch Enterprises. One of the defendants had an employment contract which entitled him to a bonus of 12½% of net profits exceeding \$2 million; plaintiff argued that his efforts were essential to the business and that he had actual operational control. The court refused to find an exception to the sale of business doctrine.

¹⁰⁸ *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

¹⁰⁹ [Current Developments] FED. SEC. L. REP. (CCH) ¶ 98,608 (E.D.N.Y. Mar. 31, 1982).

¹¹⁰ See text accompanying note 19 *supra*.

lowed the latter rationale. In *Seagrave Corp. v. Vista Resources, Inc.*,¹¹¹ a corporation purchased all the stock of the direct and indirect subsidiaries of another corporation. The district court applied the sale of business doctrine even though the purchaser stated that it did not participate in the day-to-day management but instead relied on existing management. In *Somogyi v. Butler*,¹¹² the court said that because plaintiff had the right to exercise complete control over the business, whether he chose to delegate management or operate it himself was irrelevant.¹¹³

3. Publicly Traded Corporations

Finally, although the doctrine originated in the context of closely

¹¹¹ 534 F. Supp. 378 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982). Three months after the district court decision in *Seagrave*, the Second Circuit rejected the sale of business doctrine in *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982), discussed in notes 66-77 and accompanying text *supra*. The Second Circuit later reversed the district court decision in *Seagrave* "to give the district court a fair opportunity to decide the issue in light of *Golden*" 696 F.2d at 228.

¹¹² 518 F. Supp. 970 (D.N.J. 1981). The facts were one step removed from the sale of business doctrine since they involved the sale of assets and goodwill and the subsequent formation by the purchaser of a new corporation which received the assets from the purchaser. Thus, it would stretch the limits of Rule 10b-5 itself to find that the alleged fraud was "in connection with" the purchase or sale of securities. See note 3 *supra*.

¹¹³ This view is consistent with cases involving purchasers of real estate who entered into a management contract with the seller or a third party. The courts have refused to find an investment contract under the *Howey* test, since the purchaser retains control over the enterprise despite the delegation of management. See *Commander's Palace Park Assocs. v. Girard & Pastel Corp.*, 572 F.2d 1084 (5th Cir. 1978); *Schultz v. Dain Corp.*, 568 F.2d 612 (8th Cir. 1978); *Fargo Partners v. Dain Corp.*, 540 F.2d 912 (8th Cir. 1976). Although this approach is clearly consistent with *Howey* when the management contract is cancellable upon short notice as in *Fargo Partners*, it seems open to question when the agreement is of longer duration, as in *Schultz*, because it then appears the purchaser is relying on the efforts of another. In *Schultz* and in *Commander's Palace Park* the court found that the management arrangement was not offered by the seller, and that therefore the arrangement did not constitute a security under *Howey*. However, in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), the Fifth Circuit created a narrow exception to the general principle in a case involving participants in real estate joint ventures. The court recognized that an investor may be incapable of exercising the control conferred upon him in an agreement. When the investor is "so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his . . . venture powers . . ." 645 F.2d at 424, he is forced to depend upon the promoter and thus, he has purchased a security. The fact that the investor has delegated management is not sufficient to find the presence of a security. *Id.* at 423. In *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982), plaintiff, a substantial investor in five real estate syndications, sued the promoter and other defendants. Although the agreements gave the investors substantial control over the property,

held corporations, courts seem willing to extend it to purchases of stock in publicly traded corporations.¹¹⁴ This is a logical extension of the doctrine, considered by itself. However, because stock in publicly traded corporations is the quintessential security under the federal securities laws, anomalies in regulation may develop if this view is accepted. For example, a tender offeror may argue that his offer for a controlling block of a publicly traded corporation's stock is outside the scope of tender offer regulation, since he is not offering to purchase a security. While a court might avoid this untenable result by analysis of the relevant provisions of tender offer legislation,¹¹⁵ this example illustrates the difficulties created by adopting *Forman's* "economic realities" as the exclusive test for determining a security.

III. ALTERNATIVE BASES FOR THE SALE OF BUSINESS DECISIONS

Use of the sale of business doctrine to bar plaintiffs from asserting federal securities claims reflects several judicial concerns. First, many courts believe that the transactions in question are purely local in character and impact, and that the cases therefore can more appropriately

plaintiff argued that his dependency on the defendants brought him within the *Williamson v. Tucker* exception. The court held that allegations that plaintiff depended upon the promoter's expertise precluded summary judgment for the defendant-promoter, but affirmed the lower court's grant of summary judgment for the other defendants. See also *SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577 (2d Cir.), *cert. denied sub nom. Hecht v. SEC*, 103 S. Ct. 568 (1982).

¹¹⁴ *Zilker v. Klein*, 510 F. Supp. 1070, 1075 (N.D. Ill. 1981), states this explicitly. However, the statement is dictum because the stock in question was that of Bally Distributing, then owned by three stockholders. Bally Distributing was purchased by Bally, a publicly held corporation. Cf. *Alna Capital Assocs., Inc. v. Wagner*, 532 F. Supp. 591, 602 (S.D. Fla. 1982) (court found "no need to apply" sale of business doctrine to sale of 38% of corporation's publicly traded stock).

¹¹⁵ Section 14(d) of the Exchange Act, 15 U.S.C. § 78n(d) (1976), regulates tender offers for, *inter alia*, equity securities which are registered pursuant to § 12 of the Exchange Act, 15 U.S.C. § 78l (1976). Section 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (1976), is a general antifraud provision, modelled after Rule 10b-5, which relates to all tender offers, and therefore to tender offers for all types of "securities." See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 596 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974). A court confronted by the argument set forth in the text could find that the description of regulated securities in § 14(d) is specific and unambiguous and therefore is not controlled by the general definition of a security found in § 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10) (1976). While the coverage of § 14(e) was clearly intended to be broader than that of § 14(d), the argument can be made that the general definition of security incorporating the sale of business exclusion is applicable in determining the scope of § 14(e) and therefore, a tender offer for a controlling block of stock is not a tender offer for purposes of § 14(e).

be resolved in state courts.¹¹⁶ Second, plaintiffs have often failed to state federal securities claims adequately, leading courts to suspect that the sole motivation for alleging those claims is to create a jurisdictional predicate for bringing an action in federal court.¹¹⁷ This fact, along with the Supreme Court's admonition not to federalize the law of corporations,¹¹⁸ has led the courts to use the sale of business doctrine to dismiss the claims. Finally, courts may feel that these plaintiffs are in some sense "unworthy" because these cases necessarily involve negotiated transactions rather than impersonal market transactions. Therefore, the plaintiffs could have and should have bargained for — and in some cases did bargain for — whatever protection they needed.¹¹⁹ The sale of business doctrine, however, is unnecessary to rectify these concerns. To the extent these are appropriate concerns of the judiciary, rather than policy decisions properly left to Congress, there are established bases within Rule 10b-5 case law for excluding such claims.

A. *Failure to State a Federal Securities Claim*

Many of the decisions which rely on the sale of business doctrine to defeat the plaintiff's claims could reach the same result on other grounds. In *Canfield v. Rapp & Son, Inc.*,¹²⁰ the district court found that plaintiff failed to establish any of the material elements for recovery under federal or state securities laws or under common-law fraud rules.¹²¹ The Seventh Circuit nonetheless affirmed dismissal of the securities claims¹²² solely on the basis of *Frederiksen v. Poloway*,¹²³ which it had decided a few months earlier. It also appears that many of the sale of business cases, had they gone to trial, would have resulted in findings that defendants did not violate Rule 10b-5, either because they did not make material misstatements or omissions,¹²⁴ or because they

¹¹⁶ See notes 131-41 and accompanying text *infra*.

¹¹⁷ See notes 142-52 and accompanying text *infra*.

¹¹⁸ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977); see note 10 *supra*.

¹¹⁹ See notes 153-64 and accompanying text *infra*.

¹²⁰ 654 F.2d 459 (7th Cir. 1981).

¹²¹ The findings of the district court are set forth, *id.* at 462. It specifically found no misrepresentations, lack of materiality, lack of reliance, no scienter, and no damage suffered. In addition it found that there was no sale of a security for purposes of federal and state securities laws. *Id.* at 462-63.

¹²² The court of appeals also upheld dismissal of the common-law fraud claim, which involved the court's finding of no misrepresentation, scienter, reliance, causation or damages. *Id.* at 466.

¹²³ 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

¹²⁴ See, e.g., *Zilker v. Klein*, 510 F. Supp. 1070, 1074 n.6 (N.D. Ill. 1981).

did not act with the requisite scienter.¹²⁵ Accordingly, in those instances it was unnecessary for the courts to use the sale of business doctrine.

Similarly, to state a Rule 10b-5 claim plaintiff must show that there was a purchase or sale¹²⁶ and, in most instances, that he was a purchaser or a seller.¹²⁷ In some of the sale of business cases, there was no purchase or sale, and that would have been a basis for dismissing those complaints. For example, in *Reprosystem v. SCM Corp.*,¹²⁸ the gravamen of plaintiff's complaint was that, after negotiations for the purchase of defendant's foreign subsidiaries were concluded, defendant decided not to proceed with the sale. The court found no purchase or sale and thus no basis for invoking Rule 10b-5.¹²⁹ Other suits brought by disappointed would-be purchasers have been dismissable on the same grounds.¹³⁰

¹²⁵ See, e.g., *Reprosystem v. SCM Corp.*, 522 F. Supp. 1257, 1274 (S.D.N.Y. 1981).

¹²⁶ See note 3 *supra*.

¹²⁷ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1976), accepted the rule of *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), that one must be a purchaser or seller of a security to have standing to bring a Rule 10b-5 claim. The status of certain exceptions to the *Birnbaum* rule, which had developed prior to *Blue Chip Stamps*, remains unresolved. The courts have, for instance, continued to apply the "forced seller" exception, which confers standing on an individual whose stock is involuntarily converted into a cash claim because of a merger or liquidation consummated through fraud. See, e.g., *Alley v. Miramon*, 614 F.2d 1372 (5th Cir. 1980); *Marsh v. Armada Corp.*, 533 F.2d 978 (6th Cir. 1976), *cert. denied*, 430 U.S. 954 (1977); *Morales v. Gould Investors Trust*, 445 F. Supp. 1144 (S.D.N.Y. 1977), *aff'd mem.*, 578 F.2d 1369 (2d Cir. 1978). See generally Gallagher, *10b-5 After Blue Chip Stamps: How Stands the Judicial Oak?*, 80 DICK. L. REV. 1 (1975); Jacobs, *Standing to Sue Under Rule 10b-5 After Blue Chip Stamps*, 3 SEC. REG. L.J. 387 (1976).

¹²⁸ 522 F. Supp. 1257 (S.D.N.Y. 1981).

¹²⁹ *Id.* at 1274. Compare *Omega Executive Servs., Inc. v. Grant*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,848 (S.D.N.Y. Apr. 23, 1979); *Desser v. Ashton*, 408 F. Supp. 1174 (S.D.N.Y. 1975), *aff'd mem.*, 573 F.2d 1289 (2d Cir. 1977), with *Southeastern Waste Treatment, Inc. v. Chem-Nuclear Sys., Inc.*, 506 F. Supp. 944 (N.D. Ga. 1980). These cases explore the scope of another exception to the *Birnbaum* rule, see note 127 *supra*, when one has a contractual right to purchase securities.

¹³⁰ See *Rollo v. Glynn*, [Current Developments] FED. SEC. L. REP. (CCH) ¶ 98,650 (S.D.N.Y. Mar. 30, 1982); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977); see also *Somogyi v. Butler*, 518 F. Supp. 970 (D.N.J. 1981) (plaintiff, purchaser of business' assets, alleged it was parties' understanding that he would organize corporation to receive assets and issue stock to him; court held that even if transaction constituted a purchase or sale, it was not "in connection with" the sale of a security).

B. Local Transactions

Some courts have made it clear that they do not believe the transaction is a federal concern.¹³¹ This is not a new issue in Rule 10b-5 litigation. In the past, defendants persistently and unsuccessfully argued that transactions involving close corporations, in which face-to-face negotiations were conducted, lacked the requisite connection with interstate commerce to invoke federal jurisdiction.¹³² It was early established that an interstate telephone call was a sufficient use of an instrumentality of interstate commerce to invoke federal securities jurisdiction.¹³³ It appears now to be settled law that an *intrastate* telephone call over lines which run *interstate* is sufficient to confer federal jurisdiction.¹³⁴

¹³¹ See, e.g., *Barsy v. Verin*, 508 F. Supp. 952, 955 n.4, 956 n.7 (N.D. Ill. 1981) (finding letter and phone call within state was insufficient to meet the jurisdictional requirement).

¹³² Section 10 of the Exchange Act requires the use "of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange." 15 U.S.C. § 78j(b) (1976), set forth in note 3 *supra*.

¹³³ See, e.g., *Matheson v. Armbrust*, 284 F.2d 670, 673 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961).

¹³⁴ The Fifth, Sixth, Eighth, Ninth and Tenth Circuits have expressly so held. *Dupuy v. Dupuy*, 511 F.2d 641 (5th Cir. 1975); *Aquionics Acceptance Corp. v. Kollar*, 503 F.2d 1225 (6th Cir. 1974); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Spilker v. Shayne Laboratories, Inc.*, 520 F.2d 523 (9th Cir. 1975); *Kerbs v. Fall River Indus.*, 502 F.2d 731 (10th Cir. 1974). *But see Barsy v. Verin*, 508 F. Supp. 952, 955 n.4 (N.D. Ill. 1981).

Courts looked first at the explicit language of § 10 of the Exchange Act, 15 U.S.C. § 78j (1976), set forth in note 3 *supra*, that is, instrumentality of interstate commerce, as contrasted with the language of § 5 of the 1933 Act, 15 U.S.C. § 77e (1976), that is, instrumentality *in* interstate commerce. *Dupuy*, 511 F.2d at 642-43. Second, they determined that it was consistent with the legislative purpose to find a broad scope to federal securities regulation:

[It] seems somewhat anomalous to assume, in the absence of express indication of such an intent, that on the one hand, Congress and the S.E.C. meant to erect a comprehensive statutory scheme for the prevention of securities fraud, and on the other, intended to narrowly circumscribe its scope of operation.

Id. at 643; "The bark of the Acts would be without substantially effective bite if we construed 'instrumentality of interstate commerce' in the narrow and highly technical fashion that the defendants urge." *Spilker*, 520 F.2d at 525-26. Moreover, this conclusion appears inescapable after the 1975 amendment to the Exchange Act's definition of "interstate commerce" which added the following sentence: "The term ['interstate commerce'] also includes intrastate use of (A) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (B) any other interstate instrumentality." § 3(a)(17) of the Exchange Act, 15 U.S.C. § 78c(a)(17) (1976); see S. REP. NO. 75, 94th Cong., 1st Sess. 149, *reprinted in* 1975 U.S. CODE CONG. &

Furthermore, the mails are an independent basis for establishing jurisdiction. Therefore, a letter delivered through the mails, even if within the same state, will suffice.¹³⁵ In addition, courts have consistently held that the misrepresentation or omission need not have been conveyed through the instrumentality of interstate commerce or by the mails. It is sufficient if the telephone call or the letter was "connected to"¹³⁶ or was "important"¹³⁷ to the complained-of scheme.¹³⁸

Nevertheless, in reading the sale of business cases, one senses a great deal of discomfort with this previously well-settled law.¹³⁹ Many of the cases do involve very "local" deals, and some courts clearly feel that the outer limits of Rule 10b-5 jurisdiction have been exceeded.¹⁴⁰ This feeling is intensified when the 10b-5 claims are given only cursory treatment by plaintiff's attorney¹⁴¹ and appear to be only an excuse to get into federal court. Indeed, one lesson of these cases may be that if plaintiff's attorney does not take his own federal claim seriously, neither will the courts.

C. *Inadequate Presentation of Federal Securities Claim*

Under Rule 9(b) of the Federal Rules of Civil Procedure, the circumstances constituting an alleged fraud¹⁴² must be plead with specific-

AD. NEWS 179, 268.

¹³⁵ See, e.g., *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965); *Harrison v. Equitable Life Assur. Soc'y*, 435 F. Supp. 281, 284 (W.D. Mich. 1977); *Reube v. Pharmacodynamics, Inc.*, 348 F. Supp. 900, 912 (E.D. Pa. 1972); *Levin v. Marder*, 343 F. Supp. 1050, 1056 (W.D. Pa. 1972).

¹³⁶ *Spilker v. Shayne Laboratories, Inc.*, 520 F.2d 523, 526 (9th Cir. 1975).

¹³⁷ *Gower v. Cohn*, 643 F.2d 1146 (5th Cir. 1981).

¹³⁸ Indeed, it apparently suffices if the stock is paid for by check which clears through interstate banking facilities. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

¹³⁹ E.g., *Barsy v. Verin*, 508 F. Supp. 952, 955 n.4 (N.D. Ill. 1981); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977). In contrast, the court in *Bronstein v. Bronstein*, 407 F. Supp. 925, 931 (E.D. Pa. 1976), noted in rejecting the sale of business doctrine that "it is well-settled that section 10(b) applies to face transactions between private individuals and outside the organized securities markets."

¹⁴⁰ E.g., *Barsy v. Verin*, 508 F. Supp. 952, 955 n.4 (N.D. Ill. 1981).

¹⁴¹ *Id.* at 956 n.7.

¹⁴² In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court made it clear that scienter was required to establish a violation of Rule 10b-5. Accordingly, plaintiff must set out sufficient facts in his complaint to make a showing of scienter. See, e.g., *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 169 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977). The circuit courts have consistently held that "reckless behavior" constitutes scienter for Rule 10b-5 purposes. E.g., *Huddleston v. Herman &*

ity,¹⁴³ or the complaint may be attacked by a motion to dismiss.¹⁴⁴ Rule 10b-5 claims are a particular type of "fraud" and are subject to Rule 9(b). Therefore, conclusory allegations that the defendant's conduct violated Rule 10b-5 are insufficient.¹⁴⁵ This requirement eliminates frivolous suits,¹⁴⁶ protects defendant's reputation,¹⁴⁷ and apprises a defendant of plaintiff's claim and of the acts constituting the alleged fraud.¹⁴⁸

Many plaintiffs apparently have failed to detail adequately the nature of the alleged fraudulent misstatements or omissions.¹⁴⁹ This may, again, prompt the court to decide that the complaint is in actuality founded on a state law contract or corporate claim.¹⁵⁰

Moreover, the judiciary's mistrust of the bona fides of the federal claims is intensified when the substance of the complaint appears to be a traditional state law claim, such as corporate mismanagement, which the Supreme Court in *Santa Fe Industries, Inc. v. Green*¹⁵¹ found not to be fraud for Rule 10b-5 purposes. When the 10b-5 claim arises in the context of a shareholders' derivative suit, courts have noted that the shareholder is in reality complaining not that a fraud or deception was perpetrated on the corporation,¹⁵² but that the officers and directors of the corporation breached a fiduciary duty owed to the shareholders.

D. The "Unworthy Plaintiff"

One senses that in some of the sale of business doctrine cases the

MacLean, 640 F.2d 534, 545 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 103 S. Ct. 683 (1983); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sanders v. John Nuveen & Co., 554 F.2d 790, 792-93 (7th Cir. 1977).

¹⁴³ It is sufficient if plaintiff sets forth "averments describing the barebones of the fraudulent scheme" as well as allegations that defendant used the mails or other instruments of interstate commerce. *Tomera v. Galt*, 511 F.2d 504, 508 (7th Cir. 1975).

¹⁴⁴ FED. R. CIV. P. 9(b).

¹⁴⁵ *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 444-45 (2d Cir. 1971).

¹⁴⁶ *Segal v. Gordon*, 467 F.2d 602, 607-08 (2d Cir. 1972).

¹⁴⁷ *Id.*

¹⁴⁸ *Felton v. Walston & Co.*, 508 F.2d 577, 581 (2d Cir. 1974).

¹⁴⁹ *See, e.g., Frederiksen v. Poloway*, 637 F.2d 1147, 1149 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Kane v. Fischbach*, [Current Developments] FED. SEC. L. REP. (CCH) ¶ 98,608, at 92,987 (E.D.N.Y. 1982).

¹⁵⁰ *Barsy v. Verin*, 508 F. Supp. 952, 956 n.7 (N.D. Ill. 1981).

¹⁵¹ 430 U.S. 462, 476-77 (1977).

¹⁵² *See, e.g., Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*, 513 F. Supp. 885, 889-91 (N.D. Ill. 1981); *Zilker v. Klein*, 510 F. Supp. 1070, 1074-75 n.6 (N.D. Ill. 1981).

judges simply do not believe that plaintiff should be entitled to recover under Rule 10b-5. There is a tone of assumption of risk or even *caveat emptor* in these opinions. Thus, the opinions mention that plaintiff was an experienced businessman, or that he had access to corporate books or records.¹⁵³ This approach is repugnant to the congressional purpose and inconsistent with settled precedent.¹⁵⁴ The doctrine of due diligence serves to weed out claims by plaintiffs whose conduct should render them ineligible to recover. Due diligence recognizes that Rule 10b-5 should not recompense plaintiffs who have completely failed to look after their own interests.

The Fifth Circuit's decision in *Dupuy v. Dupuy*¹⁵⁵ is the leading case in this area. The trial court entered judgment for defendant, notwithstanding the jury's verdict for the plaintiff, because in its view there was "no evidence from which a finder of fact might have inferred any diligence on the part of the plaintiff."¹⁵⁶ Defendant had purchased a forty-seven percent interest in a corporation from plaintiff, his brother, at a bargain price, intentionally misrepresenting the corporation's prospects. The Fifth Circuit held that the jury could properly find that plaintiff had not acted carelessly and that, despite his failure to investigate into the affairs of the corporation and his initiation of the negotiations, plaintiff did not sell his stock in reckless disregard of the corporation's prospects. The court emphasized that plaintiff had been cut out of participation in the business by his brother, that he had repeatedly discussed the corporation and the stock sale with his brother, and that his ability to investigate was diminished by his need to find new employment and by his ill health.¹⁵⁷

Analyzing due diligence, the court first reaffirmed its earlier view that plaintiff's due diligence was an appropriate consideration in Rule 10b-5 cases, and accordingly should be considered as a separate element

¹⁵³ See, e.g., *Golden v. Garafalo*, 678 F.2d 1139, 1149 (2d Cir. 1982) (Lumbard, J., dissenting).

¹⁵⁴ See notes 162-63 *infra*.

¹⁵⁵ 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977). In an earlier decision, *Dupuy v. Dupuy*, 511 F.2d 641 (5th Cir. 1975), the Fifth Circuit reversed the trial court's finding of insufficient connection with interstate commerce. The trial court found that although the plaintiff and defendant lived in the same apartment complex and shared a patio, many of the negotiations were conducted over the telephone. *Dupuy v. Dupuy*, 375 F. Supp. 730, 731 (E.D. La. 1974). See notes 133-38 and accompanying text *supra*.

¹⁵⁶ *Dupuy v. Dupuy*, 551 F.2d 1005, 1008 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

¹⁵⁷ 551 F.2d at 1020-23.

of this claim.¹⁵⁸ The court then determined that plaintiff's conduct be judged by a subjective standard to permit the fact finder to consider relevant factors such as plaintiff's position in the industry, sophistication, and expertise in financial matters.¹⁵⁹ The court, however, re-examined the circuit's earlier rule, and determined that a finding of recklessness, and not negligence alone, would be required to bar plaintiff from recovering.¹⁶⁰

The court reasoned that, because the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*¹⁶¹ required scienter to establish defendant's liability under Rule 10b-5, it would be inappropriate to bar plaintiff's recovery merely because of conduct on his part amounting to no more than negligence. The court found further support for this position in general tort law principles: as between a defendant who acted wrongfully intentionally and a plaintiff who acted wrongfully negligently, the plaintiff should win. In addition, the court noted that since *Hochfelder* has dramatically reduced the scope of Rule 10b-5 liability, the courts should not further do so by barring merely negligent plaintiffs from recovery. Thus, the *Dupuy* standard focused on whether the plaintiff had "intentionally refused to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.'" ¹⁶² The *Dupuy* recklessness standard for plaintiff's conduct has been accepted by all circuits that have considered the issue.¹⁶³

¹⁵⁸ The court stated:

By considering independently whether the carelessness of a plaintiff should preclude his recovery, the Court promotes two policies. First, general principles of equity suggest that only those who have pursued their own interests with care and good faith should qualify for the judicially created private 10b-5 remedies. . . . Second, by requiring plaintiffs to invest carefully, the Court promotes the anti-fraud policies of the Acts and engenders stability in the markets.

Id. at 1014. As the court noted, due diligence can also be viewed as an aspect of reliance, another element of a Rule 10b-5 claim, in that reliance must be reasonable or justifiable. *Id.* at 1015; see text accompanying notes 174-84 *infra*.

¹⁵⁹ *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

¹⁶⁰ 551 F.2d at 1017-20.

¹⁶¹ 425 U.S. 185 (1976); see note 142 *supra*.

¹⁶² *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977), quoting W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 34, at 185 (4th ed. 1971).

¹⁶³ The Second Circuit has adopted the *Dupuy* reasoning, *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 78-79 (2d Cir. 1980); the First Circuit has approved *Dupuy's* reasoning, *Holmes v. Bateson*, 583 F.2d 542, 559 n.21 (1st Cir. 1978); see also *Sundstrand*

In light of *Dupuy* and cases following it, two observations can be made about the sale of business cases. First, the due diligence standard is available and sufficient to eliminate truly unworthy plaintiffs. When there are arms-length negotiations for the sale of a close corporation, it is reasonable to suppose that the individuals will possess equal bargaining power, and that the purchaser will have access to corporate books and records. Therefore, if the plaintiff examines the records and discovers evidence of fraud, but ignores it, or if the plaintiff fails to review the corporate records, he lacks due diligence, and his Rule 10b-5 claim should fail.¹⁶⁴ Second, plaintiffs whose claims survive *Hochfelder's* requirement of scienter and who can show that they acted with the due diligence required by *Dupuy*, can hardly be said to be unworthy.

E. No Reliance or Causation

Reliance and causation are two further required elements which also serve to reduce the scope of Rule 10b-5.¹⁶⁵ They are muddled concepts in Rule 10b-5 litigation. The starting point for any discussion of these elements is the Supreme Court's opinion in *Affiliated Ute Citizens v. United States*.¹⁶⁶ Defendants in that case included two employees of the transfer agent for a corporation which held the assets of the Ute Indian tribe available for distribution to mixed-blood members of the tribe. The defendants fostered a secondary market in the stock by buying it from the mixed-bloods and selling it to others. The Supreme Court held that the defendants' failure to disclose the higher prices available violated Rule 10b-5, stating that:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a rea-

Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1048-49 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Holdsworth v. Strong*, 545 F.2d 687, 692-95 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3d Cir. 1976).

¹⁶⁴ *But see* *Holdsworth v. Strong*, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977) (although plaintiff was a sophisticated insider with access to company books, he relied on several intentional misrepresentations made by defendant about the financial conditions of the corporation). The likelihood of plaintiff's conduct being found to lack due diligence increases when there is no blood or close relationship between the parties, as there was in both *Dupuy* and *Holdsworth*, which fosters a reliance reasonable under the circumstances.

¹⁶⁵ "The element of reliance serves to restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists causation in fact between the defendant's act and the plaintiff's injury." *Wilson v. Comtech Telecomm. Corp.*, 648 F.2d 88, 92 (2d Cir. 1981).

¹⁶⁶ 406 U.S. 128 (1972).

sonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of material fact establish the requisite element of causation in fact.¹⁶⁷

The significance of this language has been widely debated.¹⁶⁸ It expressly applies only to nondisclosure¹⁶⁹ cases, leaving open the role of reliance in cases involving affirmative misrepresentations.¹⁷⁰ In addition, the transactions in *Affiliated Ute* were face-to-face, leaving unanswered its application in open market transactions.¹⁷¹ *Affiliated Ute* does not,

¹⁶⁷ *Id.* at 153-54.

¹⁶⁸ Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 S.C.L. REV. 653 (1975); Leech, *Developments under Rule 10b-5 and Section 16(b)*, 4 INST. ON SEC. REG. 375, 380 (1973); Stoll, *Reliance as an Element in 10b-5 Actions*, 53 OR. L. REV. 169 (1974); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

¹⁶⁹ However, in negotiated transactions, as opposed to market transactions, there probably are few pure nondisclosure cases; more accurately, defendants failed to make disclosures necessary under the circumstances to make the communications not misleading. The distinction between misrepresentations and omissions is not clear-cut. For example, in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the failure to disclose that higher prices were available in the secondary market was also an implied misrepresentation that the offered price was fair.

¹⁷⁰ In *Wilson v. Comtech Telecomm. Corp.*, 648 F.2d 88, 92 n.6 (2d Cir. 1981), cases involving misrepresentations were distinguished from nondisclosure cases. With misrepresentations, reliance involves whether plaintiff believed what defendant said, and whether this belief caused plaintiff's action. Thus, plaintiff must prove the misrepresentation was a "substantial factor" in his securities activities. See, e.g., *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 33-34 (2d Cir. 1976). In nondisclosure cases positive proof of reliance becomes difficult to show, and the issue really becomes materiality. *Wilson*, 648 F.2d at 92 n.6.

¹⁷¹ See, e.g., *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *Ruder, Judicial Developments Under Rule 10b-5: Standing, Scienter, Reliance, Materiality and Implied Rights of Action*, 7 INST. ON SEC. REG. 303, 323-28 (1976). In addition, a number of recent cases have accepted a theory of market reliance, or "fraud on the market," when plaintiff did not read the document containing the misrepresentations, but assertedly relied on the market to reflect accurately the value of the stock. See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980). *Cf. Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1980), *cert. denied*, 103 S. Ct. 722 (1983) (failure to read prospectus does not bar 10b-5 claim when allegation is that stock was unmarketable). See generally *Anderson, Rule 10b-5: Recent Developments*, 12 INST. ON SEC. REG. 369, 383-386 (1981); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982).

In an opinion vacated by the Supreme Court because of mootness, the Second Circuit held that an investor who did not read an annual report containing the inaccurate statements, but made the purchase after reading a newspaper article, can recover under Rule 10b-5 on the theory that the article on which she relied would have presented the company in a less favorable light had the annual report been accurate, and that the

however, eliminate the element of reliance from Rule 10b-5 cases. Instead, its holding is limited to one of two propositions: either that the plaintiff's case should not be dismissed because of failure to introduce affirmative evidence of reliance,¹⁷² or that the defendant carries the burden of proving that plaintiff did not rely.¹⁷³ Analysis of these complex issues is beyond the scope of this Article.

Courts apparently will bar recovery if the alleged omissions or misrepresentations could not have affected plaintiff's decision to buy or sell the securities. The court may find that the plaintiff did not rely on any misrepresentation or omission,¹⁷⁴ that the defendant's misrepresentation or omission did not cause the plaintiff's injury,¹⁷⁵ or that the omission or misrepresentation was not material to the plaintiff's investment decision.¹⁷⁶ When the transaction involves face-to-face negotiations for the purchase of a controlling block of stock in a close corporation, these principles are available to deny recovery to plaintiffs who fully understood what they were doing.¹⁷⁷

misstatements affected the "integrity of the market." *Panzirer v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated sub nom. Price Waterhouse v. Panzirer*, 103 S. Ct. 434 (1982). The Second Circuit, relying on *Affiliated Ute*, asserted that "[j]ust as a material misrepresentation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information 'heard on the street' which led [the investor] to make her losing investment." 663 F.2d at 368.

¹⁷² See R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 1049 (5th ed. 1982).

¹⁷³ *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). See Leech, note 168 *supra*, at 380.

¹⁷⁴ *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976).

¹⁷⁵ 491 F.2d at 410.

¹⁷⁶ *Harnett v. Ryan Homes, Inc.*, 496 F.2d 832, 837 (3d Cir. 1974).

¹⁷⁷ The Seventh Circuit has stated:

It is not unlikely that the principal cause of concern about the increase in this type of litigation is an assumption that it will always be much easier to allege and prove a 10b-5 case than a common law fraud case. That assumption may not be warranted because it is not necessarily true that the strict standards of disclosure which appropriately apply to transactions in which there is a dramatic disparity in the parties' access to material information will automatically and totally apply to negotiated transactions in which the parties typically rely on contract warranties and pre-closing inspection or audits as a basis for the investment decision. A flexible statute which emphasizes the relevance of the context in which a transaction takes place should neither limit its protection to an arbitrarily defined class of purchasers and sellers, nor arbitrarily assume that every purchaser and every seller is entitled to precisely the same disclosure.

Eason v. General Motors Acceptance Corp., 490 F.2d 654, 660 n.28 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). Although the *Eason* court rejected the buyer-seller

Thus, in *Titan Group, Inc. v. Faggen*,¹⁷⁸ plaintiff alleged that defendant made false and misleading statements and failed to disclose material facts in connection with negotiations leading to plaintiff's acquisition of four companies owned by defendant. In affirming the district court's dismissal of the complaint, the Second Circuit noted that plaintiff's decision to acquire the business was not based on two memoranda presented to the plaintiff in the discussions prior to the sale. Rather, plaintiff made the acquisition because the companies fitted into its expansion plans. The district judge had found that "these broad considerations, rather than interstitial details of client lists or of immediate data processing capacity, sparked Titan's acquisition interest."¹⁷⁹ Furthermore, the district court emphasized the relative position of the parties, the arms-length nature of the negotiations, and plaintiff's opportunities to examine and investigate defendant's companies. The Second Circuit added that defendant's omissions were not material, given the circumstances.¹⁸⁰

Similarly, in *Pittsburgh Coke & Chemical Co. v. Bollo*,¹⁸¹ the Second Circuit affirmed a judgment for the defendant, who sold a controlling interest in an aircraft equipment corporation. The purchaser, an owner of a commercial airline and a sophisticated investor, had unrestricted access to the business data upon which it based its investment decision, and had made a detailed review of the company's operations. In addition to finding no material misstatements or omissions, the district court found that the acquisition was motivated by long-range investment objectives and was based on plaintiff's own knowledge of the corporation and of the airline business.¹⁸²

requirement of *Birnbaum*, see note 127 *supra*, its reasoning is applicable here because it emphasized a flexible construction of the statute, in contrast to the arbitrary and automatic bar imposed on plaintiffs by use of the sale of business doctrine.

¹⁷⁸ 513 F.2d 234 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

¹⁷⁹ 513 F.2d at 238.

¹⁸⁰ *Id.* at 239; see also *Arber v. Essex Wire Corp.*, 490 F.2d 414, 420 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974) (plaintiffs, who sold their stock back to the corporate defendant, charged that defendant failed to disclose the stock's book value, which was substantially greater than the purchase price: "This information, however, was readily available to appellants who, although aware of its existence and availability, were simply uninterested.").

¹⁸¹ 560 F.2d 1089 (2d Cir. 1977).

¹⁸² *Id.* at 1092. In *Hirsch v. du Pont*, 553 F.2d 750 (2d Cir. 1977), the same court said:

The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them

Cases thus illustrate that the elements of Rule 10b-5 — reliance and causation, as well as materiality and due diligence — can be used flexibly by courts to assess the worthiness of each case. The plaintiff's business acumen and bargaining power, familiarity with the actual business operations, and access to financial records of the corporation, appropriately may be considered to determine whether plaintiff has established a Rule 10b-5 claim. Hence, the "potentially limitless thrust of Rule 10b-5"¹⁸³ is in practice confined to cases in which courts can comfortably conclude that defendant's misconduct actually caused plaintiff injury.¹⁸⁴

IV. SALE OF STOCK VERSUS SALE OF ASSETS

The preceding discussion demonstrates that many cases which have been dismissed by the courts on sale of business grounds could more properly be decided on other grounds. The principal argument for adopting the sale of business doctrine, however, is that these sales of ongoing *businesses* only happen to take the form of the sale of the corporation's *stock* by its shareholders.¹⁸⁵ Courts reason that the transfer of ownership of the business could also have been effected by a sale of the corporation's assets. Or, if the original owner or owners of the business

with the care and prudence expected from people blessed with full access to information.

Id. at 763. The discussion of reliance also relates to the due diligence issue, as the above quotation from *Hirsch* illustrates, because the asserted reliance must be reasonable or justifiable. See text accompanying notes 150-59 *supra*. (*Hirsch* imposed a negligence standard on the plaintiff. In this regard it has been modified by *Mallis v. Bankers Trust Co.*, 615 F.2d 68 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), which adopted the *Dupuy* recklessness standard; see note 163 *supra*.)

On the other hand, the *Bollo* and *Hirsch* approach was criticized by the Fifth Circuit in *Stier v. Smith*, 473 F.2d 1205 (5th Cir. 1973):

We should always be wary of holding that a purchaser of securities, who deals with the corporate insider, could have found out omitted material facts by examining the corporate books or undertaking other extensive investigations. To do so is to allow the insider to present prospective purchasers with a mountain of information which they cannot possibly digest and excuse themselves from liability on the basis that they did not provide the right answers because they were not asked the right questions.

Id. at 1208.

¹⁸³ *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

¹⁸⁴ 513 F.2d at 238-39.

¹⁸⁵ For expressions of this view, see *King v. Winkler*, 673 F.2d 342, 346 (11th Cir. 1982); *Frederiksen v. Poloway*, 637 F.2d 1147, 1151-52 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Chandler v. Kew, Inc.*, 691 F.2d 443, 444 (10th Cir. 1977).

had decided not to incorporate the business, but to conduct it in unincorporated form as a sole proprietorship or partnership, the sale of the business presumably would not have triggered application of the federal securities laws.¹⁸⁶ The argument concludes that since the substance of the transaction is the same, availability of a federal claim should not turn on the fortuitous selection of the method of sale or the form of doing business.¹⁸⁷

This argument fails, however, because it ignores the significant distinctions between sales of assets and sales of stock, and between corporations and unincorporated forms of doing business. The distinctions are well recognized and relied upon by attorneys¹⁸⁸ to determine the best methods of doing business and of transferring the business.

In comparing sales of assets with sales of stock,¹⁸⁹ the following can

¹⁸⁶ Although the Second Circuit rejected the sale of business doctrine in *Golden v. Garafalo*, 678 F.2d 1139, 1145 (2d Cir. 1982), the court did make this observation about the facts in *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

An interest in a general partnership normally is not considered a security since, under partnership law, each partner has a legal right to a voice in the management and control of the business. See *Hirsch v. du Pont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977). However, when the partnership agreement confers all management responsibility on certain partners, the interests of the nonmanaging partners may be considered securities. See *Pawgan v. Silverstein*, 265 F. Supp. 898 (S.D.N.Y. 1967); *cf. State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 647, 485 P.2d 105, 108 (1971) ("The primary weakness of the *Howey* formula is that it has led courts to analyse investment projects mechanically, based on a narrow concept of investor participation."). A limited partnership interest, on the other hand, is considered a security, since a limited partner does not have the right to exercise control. *Hirsch*, 396 F. Supp. at 1227-28.

¹⁸⁷ See cases cited in note 185 *supra*. For the contrary view, see *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979):

When ordinary corporate stock is involved in a transaction, we likewise need not consider whether the parties could have structured their arrangement in some other form. The parties in this case chose to implement their plan for joint ownership by means of a stock transfer rather than a partnership agreement or a sale of assets. Having decided to deal in stock, they brought their transaction under the provisions of the federal securities statutes.

Id. at 1204.

¹⁸⁸ *E.g.*, *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982); see note 202 *infra*.

¹⁸⁹ A third method of acquiring a corporation's business is by statutory merger. See N.Y. BUS. CORP. LAW. §§ 901-907, 910 (McKinney Supp. 1982); DEL. CODE ANN. tit. 8, §§ 251-253, 259-262 (1974). Apart from the corporate formalities required by the merger statutes and the merged corporation's loss of its separate corporate entity, the advantages and disadvantages of a merger are similar to those for a stock acquisi-

be noted. The principal advantage of an asset sale is that the purchaser can pick and choose which assets and which liabilities he wishes to acquire. In a sale of stock, on the other hand, he acquires all the assets of the corporation by operation of law, and, more significantly, all the liabilities, known and unknown.¹⁹⁰ However extensive the purchaser's pre-acquisition investigation, he may never be sure of what he has until after he has it.¹⁹¹ Thus, acquisition of all the stock is riskier than an asset transfer.¹⁹² Indeed, one commentator has stated that sales of all the stock are "obvious instances of natural dependence by one party on the other for information affecting value" and therefore are appropriate for application of Rule 10b-5.¹⁹³

Other distinctions between the forms of transfer are of practical importance in determining how to structure the transaction. Because the sale of the stock effects the transfer of the entire business, it is a simpler transfer that requires only a transfer of ownership of the stock certificates on the books of the corporation.¹⁹⁴ In contrast, the purchaser of the corporate assets may have to perfect his title by preparing and filing deeds for real property or by transferring title to automobiles and other personalty, and thus may be subject to payment of local transfer, sales, and recording taxes, hence making the transfer more time-consuming

tion. For an example of an acquisition accomplished through a merger because a 20% shareholder resisted sale of his shares, see *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980). A merger triggers a right of appraisal for any dissenting shareholders. See W. PAINTER, *CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS* § 8.2 (2d ed. 1981).

¹⁹⁰ See A. CHOKA, *BUYING, SELLING AND MERGING BUSINESSES* 1-8 (3d ed. 1969); J. MCGAFFEY, *BUYING, SELLING AND MERGING BUSINESSES* 1-3 (4th ed. 1979); W. PAINTER, note 189 *supra*, §§ 8.2-8.4; Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183, 1200-02 (1957).

¹⁹¹ This problem is particularly acute with the acquisition of a small business, because complete books and records may not have been kept and accounting statements may not have been audited. See 1 J. HERZ & C. BALLER, *BUSINESS ACQUISITIONS* § 1.203a (2d ed. 1981).

¹⁹² There are, however, doctrines which make the purchasers of the assets of a corporation liable either to the shareholders of the acquired corporation's business or to its creditors. W. PAINTER, note 189 *supra*, §§ 8.2(d), 8.4.

¹⁹³ 1 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* § 4.6, at 81 (1981).

In negotiating a stock purchase, attorneys for the buyers may seek protection for their client by obtaining representations, warranties, and indemnification from the seller. In addition, a portion of the consideration received for the stock may be placed in escrow. J. MCGAFFEY, note 190 *supra*, at 2. Nevertheless, the seller's liability for the corporate debts is secondary.

¹⁹⁴ W. PAINTER, note 189 *supra*, § 8.3.

and expensive.¹⁹⁵ Moreover, if the corporation has valuable nonassignable contracts or leases, acquisition by stock transfer will usually be preferred.¹⁹⁶ Purchasers and sellers also will have to consider tax consequences of stock versus asset transactions.¹⁹⁷

Similarly, doing business in the corporate or the noncorporate form can significantly affect the business.¹⁹⁸ The most notable distinction between corporations and unincorporated business entities is the availability of limited liability for the corporate form.¹⁹⁹ Other significant substantive distinctions include continuity of existence, centralized management, transferability of interests, and tax liability.²⁰⁰ Still other distinctions relate to formalities of doing business.²⁰¹

The "incongruity" of having a Rule 10b-5 remedy available only when the transaction is a stock transfer is thus no more incongruous than the distinction between stock acquisitions and asset acquisitions, or between corporate and noncorporate forms of business. The law will not be simplified by treating the transactions as the same for Rule 10b-5 purposes by employing the sale of business doctrine.²⁰²

¹⁹⁵ W. PAINTER, note 189 *supra*, §§ 8.2, 8.4; Darrell, note 190 *supra*, at 1199-1200.

¹⁹⁶ W. PAINTER, note 189 *supra*, § 8.3; Darrell, note 190 *supra*, at 1199.

¹⁹⁷ The acquisitions discussed herein will be taxable transactions under the Internal Revenue Code, since the purchaser is paying for the stock or assets with cash or property other than stock or securities. (If the purchaser were paying for the acquired property with stock, the securities laws would be applicable notwithstanding the sale of business doctrine, *Southeastern Waste Treatment v. Chem-Nuclear Sys., Inc.*, 506 F. Supp. 944, 949 n.2 (N.D. Ga. 1980), unless the exchange involved a controlling block of stock on each side.) For the distinctions between a taxable purchase and a tax-free reorganization, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 14.04 at 14-12, 14-13 (4th ed. 1979). For an overview of the tax treatment of asset and stock purchases, see W. PAINTER, note 189 *supra*, § 8.5 at 419-22.

¹⁹⁸ See W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS*, 20-22 (5th ed. 1980); W. PAINTER, note 189 *supra*, §§ 1.1-1.5.

Attorneys can be found liable for malpractice for failing to explore with their clients the relative advantages and disadvantages of the different forms of doing business. See Haynsworth, *Competent Counseling of Small Business Clients*, 13 U.C. DAVIS L. REV. 399, 443-44(1980).

¹⁹⁹ See A. FREY, J. CHOPER, N. LEECH & C. MORRIS, *CASES AND MATERIALS ON CORPORATIONS* 1 (2d ed. 1977); W. PAINTER, note 189 *supra*, § 1.3.

²⁰⁰ See B. BITTKER & J. EUSTICE, note 197 *supra*, ¶ 1.07 at 1-25 to 1-28; W. CARY & M. EISENBERG, note 198 *supra*, at 21-23; W. PAINTER, note 189 *supra*, §§ 1.3, 1.4.

²⁰¹ See W. CARY & M. EISENBERG, note 198 *supra*, at 26-38; W. PAINTER, note 189 *supra*, § 1.4 at 15-16.

²⁰² Plaintiffs who have argued against the sale of business doctrine by claiming reliance on the protection afforded by coverage of the federal securities laws have not fared well. In *Golden v. Garafalo*, 521 F. Supp. 350, 357 (S.D.N.Y. 1981), *rev'd*, 678 F.2d

CONCLUSION

The legislative history of the Exchange Act reveals little about the congressional purpose or the intended scope of Section 10(b).²⁰³ Congress was principally concerned with transactions in securities on the national securities exchanges and the over-the-counter markets.²⁰⁴ Nevertheless, the coverage of Section 10(b) explicitly includes securities not registered on a national securities exchange,²⁰⁵ and thus it is apparent that Congress intended Section 10(b) to extend beyond the organized trading markets.²⁰⁶ Early judicial understanding²⁰⁷ was that Rule 10b-5 applied both to face-to-face transactions, and to stock in close corpora-

1139 (2d Cir. 1982), the district judge said that the transaction had been negotiated by able, experienced counsel who presumably should have been aware of the sale of business doctrine. In *Seagrave Corp. v. Vista Resources, Inc.*, 534 F. Supp. 378, 383 (S.D.N.Y.), *rev'd*, 696 F.2d 227 (2d Cir. 1982), the district court stated that "the expectations, subjective intentions and motivations of parties do not determine whether the federal securities laws apply," thus contradicting the underlying rationale of the *Forman* economic realities test.

²⁰³ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-204 (1976); 3 L. LOSS, SECURITIES REGULATION 1424 (2d ed. 1961). The legislative history of the Securities Act and Exchange Act is compiled in LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 (J. Ellenberger & E. Mahar eds. 1973).

²⁰⁴ The preamble of the Exchange Act states that its purpose is: "To provide for the regulation of securities exchange and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes." Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881; *see also* § 2 of the Exchange Act, 15 U.S.C. § 78b (1976). This fact has been noted by the Supreme Court in *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975). *See note 21 supra*.

²⁰⁵ *See text of § 10b at note 3 supra*.

²⁰⁶ 3 L. LOSS, SECURITIES REGULATION 1466-67 (2d ed. 1961). Restricting § 10(b) to the organized markets would be contrary to express congressional intent that the comparable antifraud provision in the Securities Act, § 17(a), 15 U.S.C. § 77(a) (1976), is applicable to securities issued in exempt transactions, including private offerings. 3 L. LOSS, *supra*, at 1466-67.

²⁰⁷ Many courts have used language expressing a broad purpose of the securities laws. For example, the Supreme Court has stated that § 10(b) is not "limited to preserving the integrity of the securities markets," but "must be read flexibly, not technically and restrictively." *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971).

It has been said that "there is a strong federal interest, evidenced by the entire field of federal securities regulation, in ensuring a proper flow of information between parties to a securities transaction." *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 646 (3d Cir. 1980). Since the Supreme Court decisions in *Blue Chip*, *Hochfelder*, and *Santa Fe*, *see note 10 supra*, the rules have changed, and quoting this language in future may amount only to a wistful retrospective.

tions,²⁰⁸ and the Supreme Court in 1971 confirmed this view.²⁰⁹

The sale of business doctrine has not been applied so far as to reverse completely this common understanding. Rather, within the class of negotiated transactions involving stock in close corporations,²¹⁰ it has been used to exclude from federal securities regulation transactions which transfer control of the business. Emphasis on the element of control enables courts to use the *Howey* investment contract test²¹¹ to exclude these transactions from coverage, but application of the *Howey* test in this context seems an overly artful way to dodge explicit confrontations with what arguably may be the overbreadth of the securities laws as currently written and understood.²¹² It is not an appropriate response to such a perceived problem to adopt the sale of business doctrine, a rule which by arbitrary means reduces the scope of federal securities legislation. Courts should be reluctant to invoke the sale of business doctrine to dismiss a complaint which specifically alleges an intentional fraud.²¹³

Arguments can be made that federal regulation of negotiated transactions or transactions involving close corporations is inappropriate.²¹⁴ Nevertheless, this determination is a fundamental issue of policy to be decided by Congress, not by the courts.²¹⁵ To the extent Congress has

²⁰⁸ *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 201 (5th Cir. 1960); *Fratt v. Robinson*, 203 F.2d 627, 630-31 (9th Cir. 1953); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954, 959-61 (N.D. Ill. 1952); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 830-31 (D. Del. 1951); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). Additional cases may be found in 3 L. LOSS, SECURITIES REGULATION 1467-68 n.83 (2d ed. 1961); 6 L. LOSS, SECURITIES REGULATION 3613 (1969).

²⁰⁹ *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10-11 (1971). *Superintendent* was decided prior to the line of cases restricting the scope of Rule 10b-5 discussed in note 10 *supra*.

²¹⁰ In dictum, at least one court has said that the doctrine is applicable to stock in publicly traded corporations. See note 114 *supra*.

²¹¹ See text accompanying note 19 *supra*.

²¹² *Golden v. Garafalo*, 678 F.2d 1139, 1146 (2d Cir. 1982).

²¹³ See, e.g., *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). The Seventh Circuit indicated its approval of *Coffin* in *Frederiksen v. Poloway*, 637 F.2d 1147, 1151 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

²¹⁴ See Note, *A New Approach to Rule 10b-5: Distinguishing the Close Corporation*, 1978 WASH. U.L.Q. 733.

²¹⁵ But see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) ("[I]t would be disingenuous to suggest that either Congress in 1934 or the [SEC] in 1942 foreordained the present state of the law It is therefore proper that we consider, . . . policy considerations"). It should not be a sufficient objection that plaintiff has a state-law remedy, because § 28(a) of the Exchange Act states that: "The

appeared to consider the question, it has opted for broad coverage by the securities laws.²¹⁶

It may be true that there are too many Rule 10b-5 claims asserted on flimsy grounds, and that this is the fault of attorneys who include Rule 10b-5 claims solely to bring an action in federal court, attorneys who have not taken seriously the message of *Hochfelder* and *Santa Fe Industries, Inc.*²¹⁷ Accordingly, the courts should act vigorously to discourage frivolous claims. First, claims that do not plead fraud with adequate specificity should be dismissed.²¹⁸ Second, courts should not hesitate to impose costs and counsel fees if Rule 10b-5 claims have been raised frivolously²¹⁹ or have been pursued after plaintiff's attorney should have realized there was no adequate foundation for them.²²⁰

The sale of business doctrine would, to a significant degree, eliminate

rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; . . . " 15 U.S.C. § 78bb(a) (1976). *But see* *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 41 (1977) (in determining that a defeated tender offeror lacks standing to sue under § 14(a) of the Exchange Act, the court noted the availability of a remedy under state common law).

²¹⁶ See text accompanying notes 205-09 *supra*.

²¹⁷ See note 10 *supra*.

²¹⁸ See text accompanying notes 142-52 *supra*.

²¹⁹ The courts have the power to impose fees when an action has been commenced "in bad faith, vexatiously, wantonly, or for oppressive reasons." See *F.D. Rich Co. v. United States ex rel. Industrial Lumber Co.*, 417 U.S. 116, 129 (1974); *Nemeroff v. Abelson*, 620 F.2d 339, 348 (2d Cir. 1980). For a finding of bad faith, "there must be 'clear evidence' that the claims are 'entirely without color and made for reasons of harassment or delay or for other improper purposes.'" *Id.* (emphasis in original). A claim is colorable if "a reasonable attorney could have concluded that facts supporting the claim *might be established*, not whether such facts actually *had been established*." *Id.* (emphasis in original). An attorney might escape a finding of bad faith, because establishing scienter would require ascertaining the facts and circumstances of the transaction and might necessitate a jury finding. However, a few egregious cases of bad faith by plaintiff's attorney could be eliminated at the pleading stage, or after discovery.

²²⁰ See, e.g., *FED. R. CIV. P.* 11. Costs and fees may also be imposed when the court finds either "(a) . . . [the attorney's] conduct of the litigation was intentionally dilatory [or] (b) [that at some] point during the litigation and prior to dismissal, sufficient facts became available to [attorneys] to demonstrate that a failure to at that point withdraw the action necessarily amounted to bad faith." *Id.*; see *Nemeroff v. Abelson*, 620 F.2d 339, 350 (2d Cir. 1980). On remand, in that case, the district court imposed counsel's fees on plaintiff's attorney in the amount of \$76,000. *Nemeroff v. Abelson*, 94 F.R.D. 136 (S.D.N.Y. 1982). Noting that plaintiff's attorney conducted only five depositions in a 13-month period, none of them of a party-defendant, and none of them advancing a theory for recovery, the court said that "once [the attorney] learned that needed facts to support the merits of plaintiff's claims had to be found without the anticipated [New York Stock Exchange] assistance, he was obligated to concentrate all efforts on finding a basis for continuing the case on the merits." *Id.* at 139.

Rule 10b-5 remedies for fraud in face-to-face transactions involving stock in close corporations. Use of the doctrine in these contexts is unnecessary, since correct application of already established Rule 10b-5 principles will result in decisions adverse to those plaintiffs asserting unworthy claims.²²¹ The doctrine is also inappropriate, because it is contrary to the apparent congressional intent in enacting the securities laws.²²² Finally, the doctrine is ineffective, because in many cases there will be issues of whether a security is involved that will require resolution at trial.²²³ There is no reason in law or policy that the jurisdictional scope of the securities statutes should be manipulated to deprive otherwise worthy plaintiffs of a federal forum and the protection those statutes afford.

Thus, the sale of business doctrine, enunciated in *Frederiksen v. Poloway* and followed by an alarming number of federal courts, is an overly facile and improper method for the courts to limit private causes of action by purchasers of stock in closely held corporations. Judicial desires to discourage frivolous claims can be accomplished as effectively by correct application of existing Rule 10b-5 doctrine. There is nothing in either the congressional intent behind the federal securities statutes, or in the case law interpreting those statutes, that warrants the use of the sale of business doctrine as a jurisdictional barrier between worthy plaintiffs and federal courts.

²²¹ See notes 116-84 and accompanying text *supra*.

²²² See notes 203-06 and accompanying text *supra*.

²²³ See notes 84-115 and accompanying text *supra*.