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FEDERAL SECURITY LAWS AND THEIR APPLICABILITY TO THE SALE OF A BUSINESS: AN APPEAL FOR REGULATORY ACTION

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INTRODUCTION

Security attorneys are aware that federal security laws, the 1933 Act1 and the 1934 Act,2 impose many regulatory compliance burdens upon business corporations which issue securities and meet other specified criteria. To avoid accountability for all of the rules and regulations promulgated under the Acts, security issuers generally attempt to qualify for the exemptions offered under the 1933 Act3 while refraining, as long as possible, from

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3. Section 77c of the 1933 Act exempts certain securities from the Act's registration requirements. The exempt securities are: (1) any security issued or guaranteed by the United States, state or territory thereof, the District of Columbia or any political subdivision or public instrumentality of any state or territory; (2) any certificate of deposit or any security issued or guaranteed by any bank, including the Federal Reserve Bank; (3) any interest in a common trust fund or similar fund maintained by a bank exclusively for the investment of assets contributed thereto by such bank in its capacity as a fiduciary; (4) any industrial development bond as defined in Section 103(c)(2) of the Internal Revenue Code of 1954; (5) any interest in a trust maintained by a bank or insurance company which in accordance with an approved stock bonus, pension, or profit sharing plan or approved annuity plan; (6) a note, draft, bill of exchange or similar document which results from a current transaction and which matures within nine months; (7) any security issued by a religious or charitable not-for-profit organization or entity; (8) any security issued by a savings and loan or similar institution which is supervised and examined by state or federal authorities, provided limits are placed on the fees charged by such institution; (9) any security issued by a railroad; (10) any insurance or annuity contract written by a company subject to the supervision of an insurance commission, bank commission or similar agency; (11) any security exchanged with the current security holders, provided no commissions are paid for soliciting such exchange; (12) any securities only issued or offered to residents of a single state (see Rule 147 of the 1933 Act for clarification of the intrastate offering exemption); and (13) exemptions as the SEC deems appropriate due to the small dollar amount involved or the limited character of the offering. Securities Act of 1933, § 3, 15 U.S.C. § 77c (1981).

Section 77d of the 1933 Act lists the transactions in securities which the SEC has exempted. These transactions are (1) the individual seller who is
being required to meet the disclosure responsibilities imposed by the 1934 Act. The concerns raised by the application of the Acts become important when one recognizes the substantial costs incurred by any organization which must comply with the various demands.

Many of the corporations which are domiciled in the United States today are not actively or knowingly involved in the day-to-day requirements of the 1933 and 1934 Acts. Most of these

not an issuer, underwriter or dealer; (2) security sales not involving a public offering; (3) certain transactions by brokers and dealers if (a) unsolicited and (b) certain time limits, if a public offering in the security being traded has occurred, are met; (4) offers and sales of promissory notes if secured by a first lien on a single piece of real property; and (5) sales made to accredited investors, subject to dealer limitations. Id. at § 77d.

4. The 1934 Act requires an issuer of securities, who is required to register those securities under the 1933 Act (15 U.S.C. § 78o(d) (1981)) or who meets the criteria of being a "public company" (15 U.S.C. § 78l(g) (1981)), unless exempted by the SEC under 15 U.S.C. § 78l(h) (1981), to register under the 1934 Act with the SEC and to provide such periodic information to the SEC and/or the holders of its equity securities as the SEC deems appropriate and of interest to investors. Such information shall include (1) the disclosures necessary to keep information previously supplied to the SEC current (see 15 U.S.C. §§ 78m(a), 78o(d) (1981) and 17 C.F.R. § 230.13a-11, 13, 17, and 15d-11 (1983); §§ 240.13 and 240.17 pertain to forms 8-K, 10-Q and 10-C); (2) such annual reports as the SEC may prescribe. See 17 C.F.R. § 240.13a-1 and 240.15d-1 (1983) for reports on Form 10-K. See also 17 C.F.R. § 240.14a-3 (1983) (pertains to annual reports to security holders if proxy is solicited). In addition, the 1934 Act issuers who are registered thereunder and who solicit proxies from there securities holders must do so in accordance with the rules and regulations promulgated by the SEC. See 15 U.S.C. § 78n(d) (1981) and Regulation 14A (17 C.F.R. § 240.14A) (1983) (pertains to proxy statements by issuers who solicit a vote); See also, 15 U.S.C. § 78n(c) (1981) and 17 C.F.R. § 240.14C (1983) (pertains to information that must be provided to all equity security holders before a shareholder meeting, even if no proxy is solicited).

The 1934 Act, in addition to placing requirements on the issuer of securities, also places requirements on holders of that issuer's securities. If the holder is an affiliate of the issuer, as that term is defined in the Act, certain forms must be filed with the SEC to disclose their ownership of the issuer. See 15 U.S.C. § 78p(a), (b) (1981) and Forms 3 and 4. If the holder acquires or owns more than 5% of the equity securities of the issuer, certain reports must be filed with the SEC. See 15 U.S.C. §§ 78m(d) & (g) (1981) and Schedules 13D or 13G; see also 15 U.S.C. § 78p(a) (1981) and Form 4. Finally, if the holder, including the issuer, makes a tender offer for other securities of the 1934 Act issuer, such tender offer must be in accordance with the rules of the SEC. See 15 U.S.C. § 78n(d) (1981) and Schedule 14D.

5. A "public" or "reporting" company for purposes of the 1933 and 1934 Acts will, in all probability, incur substantial costs from printing fees for registration statements, prospectuses, annual reports, 10-K's and proxy statements; from legal and accounting fees for preparing these documents and obtaining required opinions; from pre-paid postage for forwarding the necessary disclosure documents to shareholders; and from staff time to support the preparation of all materials. See Schneider & Shargel, "Now That You Are Publicly Owned..." 36 Bus. Law. 1631 (1981). See also Schneider, Manko & Kant, Going Public: Practice, Procedure, and Consequences, 27 VILL. L. REV. 1 (1981).
corporations are basic organizations, such as "small businesses," developed for the purpose of availing their owners of that time-honored legal concept known as limited liability. The shareholders of these small businesses would probably assert that they have no need of or use for the protection and corresponding regulation of the federal security laws because of their investment in a business which they are able to know intimately or are able to control. Arguably, Congress and the Securities and Exchange Commission (SEC) accept this contention. This would explain the various safe harbors exempting small issues and issuers from the registration and reporting requirements which have been written into the Acts.

Businesses, large and small, incorporated and unincorporated, are bought, sold and exchanged every day. These transactions are negotiated formally and informally, and with and without the help of counsel. Businessmen generally believe that by permitting the prospective purchasers free and complete access to the books, records and operations of the target company, any failure by the purchaser to discover existing or potential problems should not be their concern. They rely on, and have faith in, the maxim of *caveat emptor*. Unfortunately, in light of the case of *Golden v. Garafalo*, and other recent decisions of similar import, such a belief may no longer be well-founded.

This article will provide a succinct history of the emerging legal theory known as the "sale of business doctrine." After analyzing the theories behind this doctrine, it will be argued that the desirability of the doctrine in a small business setting outweighs any attempt to eliminate the concept. The author hopes

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6. As a general rule, stockholders are not held liable for the obligations undertaken by the corporation. 19 AM. JUR. 2D Corporations § 713 (1965). See also DEL. CODE ANN. tit. 8, § 102 (b) (6) (1983) (stockholders not subject to personal liability unless so provided in certificate of incorporation); Illinois Business Corporation Act § 23, ILL. REV. STAT. ch. 32, § 157.23 (1981) (shareholders' only obligation is to pay full consideration for shares issued or to be issued).


8. 678 F.2d 1139 (2d Cir. 1982).

that regulators and commentators will develop a rule or regulation which will enable this concept to survive for such purposes.

THE SALE OF BUSINESS DOCTRINE AND ITS ORIGINS

In Garafalo, the United States Court of Appeals for the Second Circuit expressly rejected the legal theory known as the "sale of business" doctrine. The sale of business doctrine, which has been strongly advocated by the Seventh Circuit, may be described as an euphemism propagated by the judiciary to remove certain types of transactions from the purview of the 1933 and 1934 Acts. These transactions arise when a party purchases a business by acquiring the stock of the corporation operating the business. The doctrine is essentially a reiteration of the "substance over form" ideal advocated by litigators in many diverse situations.

The sale of business doctrine requires an economic realities test to be applied to the underlying transaction which provides the impetus for the transfer of "stock." The rationale behind this doctrine is that, although "stock" is expressly defined as a security in the statutory definition of "security," the economic

10. Garafalo, 678 F.2d at 1144.
11. See Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982) (securities laws inapplicable under sale of business doctrine to sale of entire business to single purchaser through stock transaction); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.) (federal securities laws not applicable where stock purchaser took control of corporation), cert. denied, 451 U.S. 1017 (1981); Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981) (stock transaction involving purchase of entire corporation is not within federal security laws).
13. Section 2(1) of the 1933 Act reads in pertinent part:
The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, . . . or, in general, any interest or instrument commonly known as a 'security'. . . . Securities Act of 1933 § 2(1), 15 U.S.C. § 77(b)(1) (1981).
Section 3(a) of the 1934 Act reads in pertinent part:
The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas or other mineral royalty or lease, any collateral-
reality of an acquisition of a business through the purchase of the stock of the corporation operating the business is a purchase of a business to be operated or controlled by the purchaser. The doctrine implies that the 1933 and 1934 Acts should not be applicable to this type of transaction because the Acts were implemented to protect investors who provide capital to entrepreneurs, not individuals who acquire control of an entity for their own use or consumption.\(^4\) Therefore, the doctrine concludes that despite the express language of the Acts, the policy and intent of the Acts dictate that stock transferred pursuant to such a transaction not be a “security” for purposes of federal security laws.

The sale of business doctrine was derived from two United States Supreme Court cases. The first case was *Securities & Exchange Commission v. W. J. Howey Co.*\(^5\) In *Howey,* the Court was faced with defining the nebulous term “investment contract” for purposes of the 1933 Act,\(^6\) as the defendant was offering economic interests in citrus groves through a complicated means of land sale contracts, warranty deeds, leases and service contracts. The Court reviewed the origins of the term from applicable state “blue sky” laws\(^7\) and relied on past state court


\(^5\) 328 U.S. 293 (1946).

\(^6\) Id. at 298-99.

\(^7\) The term “Blue Sky” law refers to state statutes which regulate the sale of securities. See 53 C.J.S. Licenses § 72 (1948). The name “Blue Sky” was adopted by various state legislatures to capture the intent of these statutes, namely to prevent investors from being defrauded by individuals who sold stock that had nothing tangible to back it except the blue sky. See Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) (law is aimed at “speculative schemes which have no more basis than so many feet of ‘blue sky’ ”); State v. Cushing, 137 Me. 112, 15 A.2d 740 (1940) (purpose of Blue Sky law is protection of public from fraud and deception); People v. Lee, 311 Ill. 552, 143 N.E. 196 (1924) (evident purpose of law is prevention of “fly by night concerns” and “get rich quick schemes”). For history and general information about state blue sky laws, see 1 BLUE SKY L. REP. (CCH) §§ 501 et seq. (1980).

State blue sky laws, as they pertain to the issuers of securities, are similar to the 1933 Act. Essentially, the laws require offers to sell securities to residents of the particular state in which the law has been enacted be “registered” with the state agency responsible for overseeing this act or be “exempt from registration.” See ILL. REV. STAT. ch. 121-1/2 § 137.5 (1981); UNIFORM SECURITIES ACT § 301 (1956) (the Uniform Securities Act has been adopted by approximately 39 states). Registration of securities may be accomplished by a number of ways including registration by notification, ILL.
construction to determine the essential ingredients of an investment contract.\textsuperscript{18} The Court held that when a transaction was a "scheme [which] involves an investment of money in a common enterprise with profits to come solely from the efforts of others,"\textsuperscript{19} that transaction came under the jurisdiction of the Acts. This statement has been refined into the three-tier economic reality test for investment contracts which has become the cornerstone of the sale of business doctrine.\textsuperscript{20}

The second Supreme Court decision which fostered the development of the sale of business doctrine was \textit{United Housing Foundation, Inc. v. Forman}.\textsuperscript{21} \textit{Forman} provided lower courts with the authority to apply the economic reality test laid down in \textit{Howey} to "stock" in a sale of business setting. In \textit{Forman}, the Court considered whether calling something "stock" should automatically bring about the application of the 1933 and 1934 Acts.\textsuperscript{22} The Court denounced a restrictive reading of the statute proclaiming:

\begin{quote}
We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called 'stock,' must be considered a security transaction simply because the statutory definition of a security includes the words 'any . . . stock.' Rather we adhere to the basic principle that has guided all the Courts' decisions in this area: 'In searching for the meaning and scope of the word "security" in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.'\textsuperscript{23}
\end{quote}

The Court noted that the primary purpose of the 1933 and 1934 Acts was "to eliminate serious abuses in a largely unregulated securities market" by providing a mechanism to prevent fraud and to protect the interest of investors in the sale of securities to raise capital for profit-making motives.\textsuperscript{24} The Court noted that "[b]ecause securities transactions are economic in

\begin{footnotes}
18. 328 U.S. at 298.
19. \textit{Id.} at 301 (emphasis added).
22. In \textit{Forman}, the term stock was used to describe an economic interest in a cooperative housing development. \textit{Id.} at 841.
23. \textit{Id.} at 848(citation omitted).
24. \textit{Id.} at 849.
\end{footnotes}
character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." This judicial declaration has been cited by the proponents of the sale of business doctrine as authority for the supposition that in any stock transfer matter, the underlying transaction which precipitates the transfer must be of a type for which Congress intended the Acts to be utilized before the Acts may be deemed applicable.

It must be noted, however, that the Court in Forman made other pronouncements that would appear contrary to the interpretation expounded by the doctrine's proponents. The Court determined that the economic interests called "stock" in Forman did not possess the normal or ordinary characteristics of stock. The economic interests in Forman were not negotiable, could not be pledged or hypothecated, conferred no voting rights in proportion to the number of shares owned, could not appreciate in value and did not make provision for dividends based on the issuing entity's profitability. The Court noted:

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. Therefore, the Forman Court appeared to qualify its earlier statements by proposing that if the instrument transferred was being accepted by the purchaser as "true stock," as it is known in the commercial world, then the purchaser of that stock may justifiably assume that the federal security laws are applicable to the transaction.

25. Id. (emphasis added).
26. Id. at 850-51 (emphasis added).
27. In dictum, the Forman court implied that an instrument that was negotiable, pledged or hypothecated, conferred voting rights and appreciated in value possessed the "traditional" characteristics associated with stock. Id. at 851.
28. 421 U.S. at 850-51.
THE ECONOMIC REALITY OF THE SALE OF A BUSINESS

The first reported appellate decision\textsuperscript{29} that applied the economic reality rationale developed in \textit{Howey} and \textit{Forman} to the sale of a business was the 1979 case of \textit{Chandler v. Kew, Inc.}\textsuperscript{30} In \textit{Chandler}, the buyer sought to recover a deposit on the purchase of a liquor store. The transaction was structured to include the acquisition of all the stock of the corporation operating the liquor store. A federal district court in Colorado dismissed any action based on the 1933 and 1934 Acts\textsuperscript{31} concluding that

\footnotesize


30. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. 1977).

31. \textit{Chandler v. Kew, Inc., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,965 (D. Colo. 1975). The plaintiff in \textit{Chandler} brought an action under section 17 and section 10(b) of the 1933 and 1934 Acts, respectively. Section 17 of the 1933 Act reads in pertinent part: It shall be unlawful for any reason 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 light of the circumstances under which they were made, not misleading, or
there was "no offer of securities in the traditional sense." The Tenth Circuit affirmed this result stating that "the economic realities of the case at bar show that plaintiff was buying a liquor store and incidentally, as an indication of ownership, was receiving 100% of the company which owned the store." The Tenth Circuit cited Forman and Howey as authority for its holding that such a stock transfer was not within the purview of the Acts. The opinion of the Tenth Circuit, however, as well as that of the lower court, was brief and failed to fully discuss the strict constructionist or literal application approach that has been deemed controlling by those at odds with the "sale of business" doctrine.

The next major appellate court attempt to apply the sale of business doctrine occurred in 1981 when the Seventh Circuit Court of Appeals decided Frederiksen v. Poloway. Frederiksen involved a complex transaction where the purchaser of the assets of a business acquired the stock of the corporation controlling that business and also employed the sole stockholder (seller) of the corporation to assist, guide, and give his expertise to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Act of 1933 § 17, 15 U.S.C. § 77g(a) (1981). Section 10(b) of the Securities Exchange Act of 1934 reads as follows:

It shall be unlawful for any person, directly or indirectly, by use of any means or instruments of interstate commerce or of the mails, or of any facility of any national securities exchange... (b) 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.


Rule 10(b)(5) of the 1934 Act reads:

It shall be unlawful for any person, directly or indirectly, by 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 statement made, in 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 person, in connection with the purchase or sale of any security.

Id. at § 10(b)(5).


34. Id.

to the purchaser in all areas of the acquired business. The purchaser, pursuant to an employment agreement with the seller, retained the exclusive ability to determine the goals, guidelines, directives, policies, and procedures that the business would follow.\textsuperscript{36} When the purchaser failed to honor the employment agreement due to certain alleged material misrepresentations concerning the acquired business, the seller brought an action for breach of the employment agreement.\textsuperscript{37} The purchaser counterclaimed alleging violations of the federal security laws.\textsuperscript{38}

The purchaser argued that a literal reading of the Acts created a legal presumption that an action under the federal security laws was permitted when capital stock was involved.\textsuperscript{39} The appellate court, however, found this contention unpersuasive and dismissed the "literal application" theory.\textsuperscript{40} The court advanced three reasons in support of its decision. First, the court reasoned that the 1933 and the 1934 Acts' definition of the term security was not as broad as the purchaser contended. In the court's view, the statute's prefatory language, "unless the context otherwise requires," obscures the meaning of "security" as used in the Acts.\textsuperscript{41} From this language, the court implied that a nexus test must be satisfied in order to determine whether the Acts were applicable. The nexus test would require the instrument involved in the transaction to be of the type which should receive the protection of the federal security laws.\textsuperscript{42} Such a nexus test would only be satisfied if the economic reality test was met. Since, in Frederiksen, the purchaser of the stock would control the corporation and derive any profit on his investment from his own managerial efforts, the economic reality test could not be met and thus, the Acts were not applicable to the transaction.\textsuperscript{43}

Second, the court recognized that not all conduct that was theoretically covered by the Acts was necessarily governed by the Acts. The court reiterated the axiom: "It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."\textsuperscript{44} Moreover, the court commented that,

\begin{itemize}
  \item \textsuperscript{36} Id. at 1149.
  \item \textsuperscript{37} Id.
  \item \textsuperscript{38} Id.
  \item \textsuperscript{39} Id. at 1150.
  \item \textsuperscript{40} Id. at 1150-51.
  \item \textsuperscript{41} Id. at 1150.
  \item \textsuperscript{42} Id.
  \item \textsuperscript{43} Id. at 1152.
  \item \textsuperscript{44} Id. at 1150, \textit{citing} Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892).
\end{itemize}
as a matter of public policy, Congress had not intended that the federal security laws be applied in a sale of business context.45

Finally, the court interpreted *Forman* as a rejection of the literal application approach.46 The court held that the *Forman* decision required an economic reality analysis to be applied to the transaction at issue. The court ruled that the facts of the case did not satisfy the three-tier economic reality test and dismissed the complaint as to any action premised on federal security law violations.47

The *Federiksen* court, essentially, established a rule that when a purchase of a business was accomplished through the transfer of stock and the purchaser assumed control of the critical decisions of the acquired corporation, the stock acquired in the transaction was not a security within the meaning of the federal security laws. The *Federiksen* decision has become the embodiment of the sale of business doctrine. It is considered to be the most authoritative pronouncement to date on this subject.48

**THE DOCTRINE IS REVISED**

A revised application of the sale of business doctrine occurred in the Eleventh Circuit decision of *King v. Winkler*.49 In *King*, the defendant owned the stock of two corporations which operated a heating and air-conditioning business. The defendant entered into an agreement to sell the business to the plaintiffs. The transaction was arranged as a sale of the stock of the two corporations. Following the closing, the purchasers assumed full control of the management and operation of the corporations and the business. Problems arose with the business, and the purchasers brought suit alleging violations of the federal security laws.50

The Eleventh Circuit acknowledged that the stock involved in the transaction had all of the common features of stock as

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45. *Federiksen*, 637 F.2d at 1150.
46. *Id.* at 1150-51. For the passage in *Forman* from which the court derived such an interpretation, see supra text accompanying note 25.
47. 637 F.2d at 1152-54.
48. See *Golden v. Garafalo*, 678 F.2d 1139, 1140-41 (2d Cir. 1982). The Seventh and Second Circuits have affirmed and reiterated their reasoning in subsequent decisions. *E.g.*, *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982) (federal securities laws not applicable under sale of business doctrine for sale of entire business to single purchaser through stock transaction); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982).
49. 673 F.2d 342 (11th Cir. 1982).
50. *Id.* at 343. The purchasers also brought an action alleging fraud, deceit, misrepresentation and concealment of fact. *Id.* at 344.
known to the commercial world. The court determined, however, that, based on the facts presented and the inconsistent language of *Forman*, it must go beyond the definition of the term security, the point deemed dispositive by the Seventh and Tenth Circuits, to determine whether the transaction was a security transaction for purposes of the 1933 and 1934 Acts. The court reviewed the *Howey* and *Forman* interpretations of the term investment contract. It reiterated the economic reality test and held that this test was the appropriate method of determining whether any transaction involving stock was a security transaction and, thus, governed by the federal security laws. The court noted that in light *Forman* "good arguments can be made on both sides of the issue," but it reasoned that, based on the facts involved, the sale of a business through a transfer of its stock should not be a security transaction for purposes of federal law.

The *King* decision illustrates a problem with the pure sale of business rationale. *King* recognized that the language in *Forman* might not have been as clear as the earlier cases seemed to imply and that a flaw in the interpretation of *Forman* by the Seventh and Tenth Circuits may exist. The court in *King* struggled with the problem of "true stock" in light of the unambiguous statutory language and developed a hybrid to the original sale of business doctrine. *King* concluded that a security, as defined by the Acts, had been sold. The court, however, seemed to propose that, based on public policy, the sale of a business was not a securities transaction in light of the generally accepted intent of federal security law. Relying on the economic reality test originally developed by the United States Supreme Court to determine the existence of investment contracts, the *King* decision implies that all transactions, to be under the auspices of the federal security laws, must meet the investment contract criteria.

**The Literal Application Theory**

It may be hoped that the result pronounced in *King* has cured the apparent misinterpretation that has evolved from *Forman*: that true stock should not be considered a security for

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51. *Id.*
52. *Id.*
53. *Id.* at 345.
54. *Id.* at 345-46.
55. *Id.*
56. *Id.* at 346.
purposes of the Acts when transferred *in toto*.\(^{57}\) This misinterpretation has led to the advocation of the literal application theory. One of the cases that interpreted *Forman* differently is *Coffin v. Polishing Machines, Inc.*\(^{58}\) In *Coffin*, the plaintiff alleged that defendant's agent asked him to consider purchasing stock in the corporation to finance an expansion.\(^{59}\) The plaintiff purchased fifty percent of the outstanding stock of defendant's corporation and was employed as an executive vice-president of that corporation.\(^{60}\) After gaining access to the corporation's financial books and records, the plaintiff discovered that representations made by the defendant to induce his acquisition of the stock were materially false and misleading.\(^{61}\) The purchaser sought relief by bringing actions in federal court under the federal security laws, under state blue sky laws, and under common law fraud.\(^{62}\) The district court, relying on *Forman*, dismissed purchaser's federal securities claims finding that the purchaser agreed to contribute substantially to the management of the defendant's corporation and thus, the economic realities of the transaction revealed that it constituted a sale of a one-half interest in a business.\(^{63}\)

The Fourth Circuit Court of Appeals, however, disagreed with the district court's analysis. The Fourth Circuit noted that "when a transaction involves stock, there is a strong presumption that the [Acts] apply. *Forman* requires [the court] to analyze the substance of a transaction only when the stocks involved do not have the significant characteristics typically associated with the named instrument."\(^{64}\) Therefore, the court held that, as long as the parties deal in ordinary capital stock, the transaction will be subject to the provisions of the Acts.\(^{65}\)

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57. In *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982), the Seventh Circuit seemed to be expressing concern over its previous rationale regarding the sale of business doctrine. The court appeared to retreat from its original declaration that the stock transferred in an acquisition of a business was not a security for purposes of the Acts. In *Sutter*, the court followed the rationale developed in *King* and focused on the transaction and not the definition of security in determining whether the federal security laws applied. *Id.* at 201-02. The author suggests that this apparent change of position may indicate a general hesitancy on the part of the Seventh Circuit to apply the pure sale of a business rationale in future cases.


59. *Id.* at 1203.

60. *Id.*

61. *Id.*

62. *Id.*


64. *Coffin*, 596 F.2d at 1204 (emphasis added).

65. *Id.*
The Seventh Circuit, in *Frederiksen v. Poloway*66 reviewed the *Coffin* decision and determined that it was not inconsistent with the result reached in the Seventh Circuit.67 The Seventh Circuit proclaimed that *Coffin* properly applied *Forman* since the stock sold in *Coffin* was used to raise capital for profit-making purposes whereas in the sale of a business, the situation before them in *Frederiksen*, an investor was not providing capital to others to continue the operation of a going concern.68 The *Frederiksen* court reasoned that, since the identity of the parties responsible for making the critical decisions of ownership are changing in the sale of a business but were not in the situation which occurred in *Coffin*, *Coffin* was appropriately decided.69

**THE GARAFALO AND MORGAN DECISIONS**

The Second Circuit has adhered to the concept proposed by *Coffin* and delivered the first setback to the potentially universal acceptance of the sale of business doctrine. For instance the court, in *Golden v. Garafalo*,70 was faced with a situation in which the plaintiffs purchased one hundred percent of the outstanding capital stock of a corporation which operated a small ticket brokerage business in New York City.71 Plaintiffs intended to operate and manage the acquired business while the defendant provided consulting services to them on as as-needed basis. The Second Circuit assumed that the deal was structured as a stock sale in order to preserve a valuable leasehold interest of the corporation which was non-assignable.72 The plaintiffs brought suit alleging certain misrepresentations as to the value of the business and sought remedial action pursuant to the federal security laws.73

The Second Circuit discussed the sale of business doctrine and the precedent that had been developed in the various circuits to support its use,74 From this analysis, the Second Circuit rejected the doctrine. The court cited language from the House Report accompanying the 1933 Bill to support the proposition that the definition of security in the Acts was meant to be as broad as possible.75 The court noted: “We regard [the state-

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67. *Frederiksen*, 637 F.2d at 1151.
68. *Id.*
69. *Id.*
70. 678 F.2d 1139 (2d Cir. 1982).
71. *Id.* at 1140.
72. *Id.*
73. *Id.*
74. *Id.* at 1140-44.
75. *Id.* at 1144. The pertinent language from the report reads:
ment in the House Report as support for the proposition that instruments ordinarily regarded as “stock” are a “security”, notwithstanding that the underlying transaction involves a transfer of control.”

The Second Circuit also discussed the potential problems that the sale of business doctrine would foster and reviewed the critical areas that prior judicial pronouncements deemed important when determining whether the doctrine was to be applied. The court expressed concern that to rely on the elusive concepts that must be determined to properly apply this doctrine, countless substantive issues that would be very difficult “to resolve on the basis of conflicting, self-serving testimony” would continually be raised. The court noted:

Congress thus may have had good reason to draft the definition of “security” so as to include all instruments having commonly agreed upon characteristics, such as “stock,” leaving “economic reality” to govern only the catch-all phrase “investment contract” in cases involving unusual or unique instruments. The damages in creating uncertainty as to the scope of the Acts and in generating slippery legal and factual issues going to jurisdiction are substantial. We

Paragraph (1) defines the term “security” in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security. The definition is broad enough . . . so that the control exerted by this bill commences with the initiation of any scheme to sell securities to the public.


76. Garafalo, 678 F.2d at 1144 (emphasis added).

77. Id. at 1145. The Garafalo court found that the parameters of the applicability of the sale of business doctrine were unclear and that many issues were left unresolved by the doctrine, such as: (1) Whether the purchase of a business by one who delegates management or control to others is within the doctrine; or (2) How the doctrine applies in the sale of a large block of stock which may effectively transfer control. Id. at 1142-43. As the court commented:

If intent to manage is relevant, adoption of the doctrine will lead to countless issues of mixed fact and law such as whether part-time managers are passive or active, what classification to accord controlling shareholders who intervene sporadically, and the status of new investors who assume ambiguous roles as employees or who intend initially to remain passive but are soon forced into management roles.

Discarding intent to manage and focusing on transfers of control - which for these purposes can be defined as actual power to select the management - does not reduce the doctrine’s elusiveness when applied to particular facts. In “economic reality,” considerably less than 100%, and often less than 50%, of outstanding shares may be a controlling block which when sold to a single holder, effectively transfers the power to manage the business. Actual control depends upon number and dispersal of shareholders, whether they be individuals, other businesses or institutional investors, and a variety of other facts which render control a most uncertain test.

Id. at 1145-46.

78. Id. at 1145.
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regard that as having been the legislative judgment, and we give it
force.79

The Garafalo decision is as strong a rebuttal to the Frederi-
ksen and King decisions and their progenies as is possible. The
Second Circuit appeared to have no problem with the con-
flicting language of Forman or any of the other contentions
brought forth. The court seemed more concerned to keep this
area of law neat and clean, with little concern of providing any
type of equitable relief.80

In Daily v. Morgan,81 the plaintiff purchasers acquired all of
the stock of a truck dealership from the defendant sellers. The
plaintiffs assumed total control and management of the deal-
ership at the closing of the sale. Approximately twenty-seven
months later, the purchasers brought an action in the District
Court for the Southern District of Mississippi alleging that the
defendants had violated the federal security laws because the
financial information on the dealership provided by the defend-
ants prior to the sale was inaccurate, incomplete and mislead-
ing.82 The district court denied the defendants' motion to
dismiss the action for lack of subject matter jurisdiction and cer-
tified the question of whether the sale of business doctrine was
applicable for appeal.83 The Fifth Circuit, noting that "there is a
substantial difference of opinion," accepted the interlocutory
appeal.84

The Fifth Circuit began its analysis with a review of the per-
tinent precedents issued by the United States Supreme Court
on the definition of the term "security" under the Acts. It aptly
noted that "the Supreme Court could either accept or reject the
sale of business doctrine in a future case without discrediting or
overruling the Forman decision. . . . Given that Forman does
not clearly dictate a result in this case, we turn to additional
arguments raised by the parties."85 The court then discussed the
"legislative intent" arguments presented by both parties.86 The

79. Id. at 1146.
80. The court in Garafalo indicated that it had great problems with the
idea of sifting through facts presented at trial in order to determine who to
believe and what degree of weight should be applied to the elements of the
economic reality test. Id. The author opines that such a concern directly
contradicts the role of the court as a trier of fact. If litigants cannot look to
the judiciary to determine disputes, as to facts and of law, what purpose is
served by having a judicial branch?
81. 701 F.2d 496 (5th Cir. 1983).
82. Id. at 497.
83. Id.
84. Id.
85. Id. at 499-500.
86. Id. at 500.
court expressed a sense of frustration with the lack of any definitive guidance in the legislative history of the 1933 and 1934 Acts indicating that "every argument on one side that 'Congress never meant to federalize state corporation law,' can be countered by an argument that 'Congress wanted to protect the public from fraud.'"87 After confronting all of the reasonable contentions offered, the court concluded that "given the lack of any direct treatment of the sale of business question in the legislative history, we are inclined to concentrate on what the drafters actually did."88 The court determined that, since Congress did exempt small and/or the private sales of securities from certain requirements of the federal security laws, the fact that Congress specifically chose to apply the anti-fraud provision to all stock was dispositive of the issue.89 To buttress the lower court's literal application of the Acts, the Fifth Circuit concluded that public policy would be best served if the Acts applied.90

After Morgan and Garafalo the circuits are evenly split with the Eleventh, Tenth, and Seventh Circuits supporting the sale of business doctrine and the Fifth, Fourth, and Second Circuits advocating an opposite approach.91 Currently, the United States Supreme Court appears to be unwilling to clarify or provide an indication of the appropriate approach. Since the legal issues involved in this matter have been sufficiently clarified and analyzed to conclude that no definitive solution exists, the public policy arguments will likely be the determining factor on whether this doctrine will survive.

THE POLICY ARGUMENTS

Many public policy arguments supporting the acceptance or defeat of the sale of business doctrine have been advanced. One concern is whether the investor needs the protection afforded by the Acts. It has been argued that the entity or individual who purchases a one hundred percent interest in an ongoing business with the intent to manage and control that business does not need the protection of the federal security laws. This argument is premised on the unique relationship that develops between the buyer and seller of a business. Through the protracted negotiations which result in a purchase agreement,  

87. Id.  
88. Id. at 502.  
89. Id.  
90. Id. at 502-03 The court discussed three policy issues: (1) the need for protection; (2) the slippery slope, and; (3) arbitrary results. Id. The Garafalo court also noted these problems and concerns. See supra note 77. 
91. For an indication of how the Eighth Circuit would decide a sale of business case, see Cole v. PPG Indus., Inc., 680 F.2d 549 (8th Cir. 1982).
the buyer generally has complete access to the books and records of the target entity.\textsuperscript{92} Additionally, this position contemplates that the purchaser will not consummate the transaction until it is completely satisfied with the legal and financial review of the business being considered.\textsuperscript{93} This "sophisticated purchaser" concept has, arguably, been accepted by the SEC in its regulations governing small "private" securities offerings.\textsuperscript{94}

Conversely, practitioners assert that protection is needed by emphasizing that no exemption from the anti-fraud provision of the Acts has been carved out by the SEC, Congress, or the judiciary. The judiciary has established certain elements,\textsuperscript{95} including reasonable reliance, necessary to obtain relief pursuant to a rule 10b-5 action. This should be all that is necessary to protect a seller who has faithfully and completely supplied all material information pertaining to the business prior to its sale to the purchaser. The advocates of the "need for protection" argument state that a fraud is a fraud and to provide a "sophisticated purchaser" concept would place too great of a burden on the purchaser to perform a detailed "due diligence" review in order to

\textsuperscript{92} An example of a clause that often appears in an acquisition agreement would read:

From and after the date hereof and until the Closing Date [purchaser and its authorized representatives shall have] full access during normal business hours to all properties, books, records, contracts and documents of [seller and its subsidiaries, and seller] shall furnish or cause to be furnished to [p]urchaser and its authorized representatives all information with respect to the affairs and business of [s]eller and its subsidiaries as [p]urchaser may reasonably request.

\textit{Kemper Corp., Purchase Agreement} at 28 (this language has been used by Kemper Corporation, a copy of which may be obtained from the author).

\textsuperscript{93} \textit{See Golden v. Garafalo}, 678 F.2d 1139, 1150 (2d Cir. 1982) (Lumbard, J., dissenting).

\textsuperscript{94} \textit{See 17 C.F.R. § 230.501-230.506 (1983). It must be recognized that the SEC has never approved the use of the sale of business doctrine and has filed many \textit{amicus curiae} briefs to support its dismissal. Regulation "D," however, sets forth a means by which an issuer may avail itself of the "non-public" offering exemption provided by Section 4(2) of the 1933 Act. \textit{Id.} Through this provision, the SEC has recognized that "accredited investors," in light of their sophistication, are entitled to participate in risky investments provided they are supplied certain information, which is less burdensome to the issuer than being required to prepare a registration statement under the 1933 Act and provided further, that the accredited investor is permitted access to the issuer to determine, first hand, the quality of the investment. \textit{Id.}}

\textsuperscript{95} \textit{See Ernst & Ernst v. Hochfelder}, 425 U.S. 185 (proof of scienter required in section 10b-5 claim) \textit{reh. denied}, 425 U.S. 986 (1976); \textit{List v. Fashion Park, Inc.}, 340 F.2d 457 (2d Cir.) (section 10b-5 claim requiring proof of reliance and materiality) \textit{cert. denied sub. nom.}, \textit{List v. Lerner}, 382 U.S. 811, \textit{reh. denied}, 382 U.S. 933 (1965); \textit{Boone v. Baugh}, 308 F.2d 711 (8th Cir. 1962) (section 10(b) claim requiring proof that defendant's use of mails or other interstate commerce instrumentalities intended to defraud or to further fraudulent scheme).
sift through the appropriate documents, policies, or procedures applicable to the business. When one considers that a “sophisticated” seller who is subject to the 1934 Act reporting requirements can easily “adjust” documents to reflect a misleading position to its auditors or the general public, it is easy to understand how a “sophisticated” seller could easily mislead an interested purchaser. What is hard to understand is why that seller should be permitted to escape federal security liability.

Another public policy concern is the need for flexibility. A unique quality of the American legal system is its ability to adapt to the changing socio-economic climate. The sale of business doctrine may be classified as an equitable defense and is a reiteration of the case-by-case approach that has been the benchmark of this legal system. This approach must exist in order for equitable results to be continually achieved. The sale of business doctrine permits the judiciary to grant the protection of the federal security laws in those instances where such protections are essential and to withhold protection in areas where it is not. The active investor who reviewed the investment carefully before plunging into the business has contractual, as well as common law and state remedies, available and should be required to use those remedies which appear adequate.

Although agreeing that the American legal system must remain flexible, critics of this policy argument point out that continuity and conformity in the law must be promoted. Flexibility should only exist in the “grey” areas of the law. The judiciary, through the sale of business doctrine, permits creative practitioners to usurp clear and unequivocal statutory language. Since the sale of business doctrine is a legal doctrine, and not a factual one, to advocate its acceptance will make the statute subject to the discretion of a federal judge. Additionally, it is illogical to argue that, since other remedies are available, federal remedies should be foreclosed. With the dismissal of the sale

96. Daily v. Morgan, 701 F.2d 496, 502-03 (5th Cir. 1983).
97. One of the remedies permitted in an action under section 10b-5 is recision. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (directors failed to disclose information known to them in purchasing stock of the corporation). Recission is an equitable remedy that may be thwarted through the use of a “clean hands” defense. See Carmen v. Fox Film Corp., 269 F. 928 (2d Cir.) (plaintiff denied rescission of contract entered into while an infant), cert. denied, 255 U.S. 569 (1920).
98. See Golden v. Garafalo, 678 F.2d 1139, 1147-49 (2d Cir. 1982) (Lum bard, J., dissenting).
99. See the concerns raised supra, note 77.
100. It is a well recognized principle that a state statute may impose more protection than a federal statute provided the federal statute has not preempted the particular area which the state statute regulates and provided further that the state statute does not inhibit the intent or application
of business doctrine, the courts will still be armed with an arsenal of equitable principles to alleviate any concern that an injustice may be committed if the facts so warrant.

A third policy concern is the reluctance to disturb the bargain reached by the parties. The purchase and sale of a business is normally a transaction structured by willing parties desiring to obtain the most advantageous results possible. Many factors are considered by the parties, including tax considerations and regulatory approvals. Sellers are normally not able to dictate the means to be used to transfer the control of the business. By not applying the sale of business doctrine, the judiciary is forcing sellers, especially those involved with small businesses which do not possess audited financial statements, to incur financial hardships by obtaining an audit or become inflexible in the structure of the deal. The courts, by failing to apply the sale of business doctrine, are providing an unfair advantage to the purchaser, particularly the unscrupulous purchaser who becomes aware of certain conditions in the business, remains quiet on these facts because he does not consider them material or believes he can correct their potential adverse result, and later claims otherwise when failure occurs. Without the sale of business doctrine, it can be expected that more "unique" and complicated deals will have to be developed by the legal community.

of the federal statute. See Edgar v. Mite Corp., 457 U.S. 624 (1982) (Illinois Business Takeover Act invalid as conflicting with commerce clause). If a state and a federal remedy is available, either one and/or the other may be used. Ives v. W.T. Grant Co., 522 F.2d 749 (2d Cir. 1975) (choice of forums - state or federal - can only serve to encourage civil actions to insure compliance).

101. Sellers may wish to structure a deal where a tax-deferred exchange of securities is involved to eliminate any immediate taxable event as a result of the transaction. See I.R.C. § 354 (1981). Purchasers, on the other hand, may desire to purchase the assets of the corporation so that they may "step up" the basis of these assets for subsequent depreciation purposes. Id. at § 338. See also Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950) (assets acquired by taxpayer in first purchasing stock and then liquidating a company, should be included at cost of stock), aff'd, 187 F.2d 718 (5th Cir. 1951). A purchaser may also wish to purchase stock in order to keep valuable leasehold interests or licenses in place. See Golden v. Garafalo, 678 F.2d 1139, 1140 (2d Cir. 1982).

102. The sale of business doctrine permits the parties involved in the transaction to share the risk if the investment made by the purchaser falters. Without the doctrine, all risk is born by the seller who, in today's litigious society, is subject to an action under federal law should the business fail. Since any legal action will be decided on the proof made available at the trial, small businesses which rely on a "handshake" or the integrity of the individual whom they are dealing with will suffer. If the corporation is large enough to have an audited financial statement, it may establish a chain which may conclusively disprove any material reliance on the part of the purchaser.
Attorneys who oppose the above contentions note that the judiciary has the power to restructure "deals" in order to provide the parties with the benefits of their bargain. In a transaction that does not involve stock in which a business is sold, protection is afforded to the purchaser.103 If the sale occurs through the transfer of assets from the seller to the buyer, the buyer is not held liable for the debts of the business; whereas, when the buyer purchases the securities issued by the target entity, it automatically acquires the liabilities previously generated by that business.104 As noted by Daily v. Morgan,105 liabilities are often the subject of inaccurate or incomplete disclosures.106 There is a definite need for the protection of the investor when stock is purchased. It follows that this need should be satisfied through the federal security laws, the specific laws that were instituted to protect purchasers of securities.

**CONCLUSION**

The United States Supreme Court has failed to act on the troublesome issues surrounding the sale of business doctrine, while the Securities and Exchange Commission continually refuses to accept the rationale for supporting its use. The courts which have ruled on these disputes have generally been involved with small closed corporations. To argue that the doctrine is applicable to such a transaction is well received. The courts accepting the doctrine, however, are apparently being overly aggressive since they lack substantive legal authority for the action taken. It is clear that the Acts should be interpreted in their broadest sense and such a view requires that "true stock" be considered a security. The SEC should review its position and act to end this dilemma. Through its rule-making authority, the SEC should promulgate a new accredited investor exemption applicable for sale of business transactions involving small corporations which now appear to be unnecessarily subject to scrutiny under the Acts.107 The comments which would be solicited by the SEC from legal practitioners and scholars would provide the much needed input to obtain an enforceable, manageable, and practical solution. Without affirmative action by the SEC, creative lawyers, to avoid having their clients be subject to the pitfalls of the Acts, will have to avoid the Acts as

104. For basic contract provisions imposing such liability, see agreement referred to supra note 92 at 3.
105. 701 F.2d 496 (5th Cir. 1983).
106. Id. at 504.
best they can. This will undoubtedly create more complicated areas and problems for the federal courts as unique and complex transactions involving small dollar amounts and affecting few individuals, will continually have to be carefully reviewed to determine whether the apparent “investment contract” before the court is a “security” for jurisdictional purposes. To burden the federal judicial system with these controversies of minimal significance, in light of the current backlog of the federal courts, is the most undesirable result of all, especially, considering the fact that adequate contractual and state claims are available.*

* Since the writing of this article, the Ninth Circuit has issued a decision supporting the sale of a business doctrine. Landreth Timber Co. v. Landreth, No. 81-3446 (9th Cir. Mar. 7, 1984).