The Definition of a Security under the Federal Securities Law Revisited

M. Thomas Arnold
University of Tulsa College of Law

Follow this and additional works at: https://engagedscholarship.csuohio.edu/clevstlrev

Part of the Courts Commons, and the Securities Law Commons

How does access to this work benefit you? Let us know!

Recommended Citation
THE DEFINITION OF A SECURITY UNDER THE FEDERAL SECURITIES LAW REVISITED

M. THOMAS ARNOLD*

I. SYNONYM OF THE CASES .......................................... 249
   A. The Majority Opinions ........................................ 251
   B. The Dissenting Opinions .................................... 254
II. THE POLICY QUESTIONS INVOLVED IN THE CASES ........ 254
   A. Are Entrepreneurs in the Protected Class? ............ 254
   B. What Weight Should be Given to the Form of a Trans- action? .......................................................... 256
   C. How Important is a Clear and Predictable Definition? 258
   D. When Should Need for Protection be a Factor? ........ 260
   E. Is a Security a Thing or a Transaction? ................. 263
III. CONCLUSION .......................................................... 265

The United States Supreme Court recently decided two cases involving the definition of “security” as used in the federal securities acts. In this brief case comment I will summarize the majority and dissenting opinions in Landreth Timber Co. v. Landreth and Gould v. Ruefenacht.

I. SYNOPSIS OF THE CASES

The Landreth and Ruefenacht cases both involved the so-called sale-of-business doctrine. The question of the validity of the sale-of-business doctrine had sharply divided both courts and commentators. The

---

* Professor, The University of Tulsa College of Law; A.B., M.A., Ohio University; J.D., The University of Michigan Law School.

1 105 S. Ct. 2297 (1985).
4 Compare Seldin, When Stock is Not a Security: The “Sale of Business” Doctrine Under
doctrine essentially held that the purchase of all, or even a majority, of the stock of a corporation with the intent to manage the business is not a purchase of a security within the meaning of the federal securities laws. The purchaser of the stock is essentially viewed as an entrepreneur and not an investor; he or she is purchasing the assets of a business with the purpose of managing those assets. The sale of stock is merely incidental to that sale of assets.\(^5\)

The Supreme Court's decision in *United Housing Foundation, Inc. v. Forman*\(^6\) has generated much of the controversy over the sale-of-business doctrine. In that case the Court held that shares of stock in a nonprofit housing cooperative were not securities. In the first portion of its decision, the Court rejected the argument that the interest in the cooperative must be considered a security since it was called "stock" and the statutory definition of "security" includes the word "stock".\(^7\) The Court spurned a literal approach and held that the application of the securities laws turned on the economic realities of a transaction and not on the label the parties applied to it.\(^8\) The Court noted that the interest involved had none of the characteristics commonly associated with stock.\(^9\) In the second portion of its decision, the Court, applying the *Howey* test,\(^10\) decided that the shares also did not fall within the catch-all provision in the statutory definition; the shares were not investment contracts.\(^11\)

Since *Forman*, courts and commentators have argued over whether the case authorized application of the *Howey* test to corporate stock. Those

---

\(^5\) Sutter v. Groen, 687 F.2d 197, 202 (7th Cir. 1982).

\(^6\) 421 U.S. 837 (1975).

\(^7\) Id. at 848.

\(^8\) Id. at 849.

\(^9\) Id. at 851.

\(^10\) The *Howey* test is derived from the Court's decision in S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946). Under this test "[the question is] whether the scheme involves an investment of money in a common enterprise with the profits to come solely from the efforts of others." Id. at 301.

\(^11\) 421 U.S. at 851-58.
DEFINITION OF A SECURITY

who believed it did could point to the Court's statement that "[w]e 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'." Thus, Forman was read as rejecting a literal approach to the statutory definition.

Others argued that Forman applied a two part test. The Court first decided, in effect, that the interest involved was not really stock. Only then did the Court apply the Howey test.

The Landreth case involved a purchase of all of the common stock of a corporation; the Ruefenacht case involved a purchase of fifty percent of the stock of a corporation under an arrangement in which the purchaser and seller were to manage the business jointly. In both cases the issue was the same: Was the stock involved a security within the meaning of the antifraud provisions of the federal securities laws? In Landreth, the Ninth Circuit, applying the sale-of-business doctrine, found that the stock involved was not a security; in Ruefenacht v. O'Halloran, the Third Circuit, rejecting the sale-of-business doctrine, held that the stock involved was a security. The Supreme Court reversed in Landreth and affirmed in Ruefenacht, with only Justice Stevens dissenting. The Court clearly rejected the sale-of-business doctrine.

A. The Majority Opinions

The majority opinions in the two cases are interesting in a number of respects. At one level, they are interesting for the answer provided for the specific question before the Court. At another level, they are interesting because of the policies that appear to have influenced the majority. For the sake of convenience and clarity, the two cases will be discussed as one.

The thrust of the Court's decisions in the cases was that the Howey test is not a universal test which all securities must meet. The Court began with a reminder that "'[t]he starting point in every case involving the construction of a statute is the language itself.'" It then examined the definition of "security" found in the Securities Act of 1933 and essen-

---

12 Id. at 848. See, e.g., Frederiksen v. Poloway, 637 F.2d 1147, 1151-52 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).
13 See, e.g., Golden v. Garafalo, 678 F.2d 1139, 1144 (2nd Cir. 1981) (Forman applied a two-part seriatim test); Karjala, supra note 4, at 419-20 (Court in Forman did not use Howey test to decide if interests involved were stock).
14 731 F.2d 1348 (9th Cir. 1984), rev'd 105 S.Ct. 2297 (1985).
17 Section 2(1) 48 Stat. 74 (codified as amended at 15 U.S.C. § 77b(1)(1982)). The Court stated: "We have repeatedly ruled that the definitions of 'security' in §§ 3(a)(10) of the 1934
tially found a dichotomy in the definition between those instruments listed whose name alone carried a well-settled meaning and those instruments of a more variable character that were designated by the more general catch-all terms "investment contract" and "instruments commonly known as a 'security.'"\textsuperscript{18} According to the Court, prior Supreme Court decisions that had looked beyond the form of a transaction to its economic substance all involved instruments that were unusual, or not easily categorized as securities. Thus, the Court stated that it had never foreclosed the possibility that stock could be found to be a security merely because of what it purports to be.\textsuperscript{19} The Court noted that if the \textit{Howey} test were a general test which all securities must meet, then the enumeration of specific types of instruments in the definitional section of the statute would be superfluous to the catch-all phrases.\textsuperscript{20}

The Court distinguished the \textit{Forman} decision. It stated that it was not enough that something is called stock for it to be a security; it must in fact have the usual characteristics of stock.\textsuperscript{21} The Court recalled that in the \textit{Forman} case it had identified the usual characteristics of common stock as "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value."\textsuperscript{22} The interests or instruments involved in the \textit{Forman} case, although denominated by the parties as stock, "bore none of the characteristics . . . that are usually associated with traditional stock."\textsuperscript{23} Thus, \textit{Forman} did not really involve stock. In both \textit{Landreth} and \textit{Ruefenacht}, by comparison, the Court noted that the stock possessed all of the characteristics usually associated with stock.\textsuperscript{24} In sum, the Court agreed with those who had read \textit{Forman} as requiring a two part analysis.

The decisions are also noteworthy as a result of the Court's discussions of the policies which supported its decisions. First, the Court rejected the

\begin{quotation}
Act and §§ 2(1) of the 1933 Act are virtually identical and will be treated as such in our decisions dealing with the scope of the term. (Citations omitted)." \textit{Landreth}, 105 S. Ct. at 2302 n.1.
\end{quotation}

\begin{footnotesize}
\textsuperscript{18} \textit{Landreth}, 105 S. Ct. at 2302.
\textsuperscript{19} \textit{Id.} at 2304. See also \textit{Forman}, 421 U.S. at 850-51, where the Court stated:
we do not suggest that the name is wholly irrelevant to the decision whether [an instrument] 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.
\textsuperscript{20} \textit{Id.} at 2305.
\textsuperscript{21} \textit{Id.} at 2302.
\textsuperscript{22} \textit{Id.}, referring to, 421 U.S. at 851.
\textsuperscript{23} 105 S. Ct. at 2302.
\textsuperscript{24} \textit{Landreth}, 105 S. Ct. at 2302-23; \textit{Gould}, 105 S. Ct. at 2310.
\end{footnotesize}
DEFINITION OF A SECURITY

notion that entrepreneurs *ipso facto* are not entitled to the protection of the federal securities laws. The Court noted a number of provisions of the Securities Exchange Act of 1934 the purposes of which it believed would be contravened if the term “security” were interpreted to exclude all transactions in which control passed to the purchaser. In addition, the Court noted that while Congress had exempted nonpublic offerings from the registration provisions of the Securities Act of 1933, it had not exempted such transactions from the antifraud provisions of the securities laws. Thus, the Court implied that both the language and the structure of the Acts supported its conclusion that traditional stock is a security, even when purchased by a person intending to manage the business. Though the sale might be exempt from the registration requirements, the antifraud provisions are fully applicable.

Second, the Court expressed concern about the need for predictability in applying the federal securities laws. This concern appears to have had two focuses. One was on the expectations of the parties involved in the transaction. The Court stated in *Landreth* that “persons trading in traditional stock likely have a high expectation that their activities are governed by the Acts.” The Court indicated, however, that if the sale of business doctrine were adopted, the question of control and, consequently, applicability of the federal securities laws would potentially depend upon multiple factors. Thus, “coverage by the Acts would in most cases be unknown and unknowable to the parties at the time the stock was sold.” A second focus was the effect on the federal court’s caseload of the creation of slippery factual questions. The Court expressed concern over the “prospect that parties to a transaction may never know whether they are covered by the Acts until they engage in extended discovery and litigation over a concept as often elusive as the passage of control.”

Finally, the Court found very troubling the possibility that, if the sale-of-business doctrine were adopted an instrument could be a security as to one party and not another. The Court said that such a distinction would be arbitrary because the applicability of the securities laws would depend not on the type and character of the instrument involved. The protective purposes of the Acts, according to the Court, would not be served by such a distinction.

---

26 105 S. Ct. at 2305.
27 *Id.* at 2306.
28 *Id.* at 2307.
29 *Id.* at 2308.
30 *Ruefenacht*, 105 S. Ct. at 2311.
B. The Dissenting Opinions

Justice Stevens dissented on several points in both cases in identical opinions.\(^{31}\) First, he would not have treated the form of transaction as decisive of the applicability of the securities laws. Justice Stevens discussed notes, which are within the literal definition of a "security" under both Acts, pointing out that the economic realities of even an ordinary transaction should be considered in determining whether a security exists and that notes should not always be considered securities.\(^{32}\) Justice Stevens would not find the form of a transaction determinative in situations such as the privately negotiated sale of control of a business, since the form of the transaction in such a case is of concern only to the parties to the transaction and "usually hinges on matters that are irrelevant to the federal securities laws . . . .\(^{33}\)

In addition, Justice Stevens took a different view of the policy considerations involved in the cases. Justice Stevens viewed the regulation of trading of securities in public markets as the congressional purpose behind the federal securities laws.\(^{34}\) Unlike the majority, he found that Congress did not intend to protect investors in securities which are not offered or sold in a public market if the investors have the ability to protect themselves through negotiated contractual provisions. Thus, Stevens would find the antifraud provisions inapplicable unless the transaction involved "(i) the sale of a security that is traded in a public market; or (ii) an investor who is not in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction."\(^{35}\)

Finally, Justice Stevens, while admitting that his approach was not the "bright line" approach of the majority, questioned the expanded application of the federal securities laws to cover substantive evils far afield from the congressional concern with regulation of public markets. He weighted this consideration more heavily than the interest in certainty and predictability that moved the majority.\(^{36}\)

II. The Policy Questions Involved in the Cases

A. Are Entrepreneurs in the Protected Class?

An examination of the majority and dissenting opinions in Landreth and Ruefenacht highlights some of the interesting policy ques-
tions involved in the issue of what is a security for purposes of the federal securities laws. One question involves the issue of whom the federal securities laws were intended to protect. A number of courts and commentators had taken the position that the laws were not intended to protect entrepreneurs and had extended this to include purchasers of a controlling interest in a corporation who intend to manage the business. Referring to the Howey test, they argue that any profit accruing to these individuals is not "from the efforts of others". Others, however, have questioned whether the entrepreneur—investor distinction is meaningful. They have suggested, for example, that a person could be both an investor and an entrepreneur.

The Court has now clearly held that the Howey test does not apply to corporate stock. Thus, entrepreneurs who purchase that instrument have the protection of the federal securities laws, particularly the antifraud provisions. The Court did not, however, state that the entrepreneur-investor distinction was always irrelevant to security status. It is clear that investor status will still be important for unusual instruments which must fall within the catch-all phrases in the statutory definition if they are to be a security. In these cases, the Howey test will remain applicable. And under this test, the source of any expected profits is a crucial element.

An accurate statement of the effect of the decisions is that entrepreneurs who purchase corporate stock are protected by the federal securities laws, but those who purchase instruments of an unusual nature which are not traditionally "the paradigm of a security" are not protected.

---

37 See Sutter v. Groen, 687 F.2d 197, 201 (7th Cir. 1982) ("We must ask in other words what class of people Congress wanted to protect by enacting the Securities Exchange Act. . . . The answer is not in doubt: investors").

38 See supra note 10.

39 The court of appeals in Ruefenacht stated:

The distinction between an "entrepreneur" and an "investor" is hardly obvious. Many investors may elect to participate in the management of a business in order to enhance their return on investment; indeed, in our free enterprise system that is to be expected. . . . It seems clear to us that these persons are both investors as well as managers.

Ruefenacht, 737 F.2d at 334. See also Golden v. Garafalo, 678 F.2d 1139, 1146 (2nd Cir. 1982) (distinction is of dubious value; "purchasers of a business rightly regard themselves as investors as well as managers.")

Even the Seventh Circuit, which was a champion of the sale-of-business doctrine, realized that "[i]t is of course easy to imagine intermediate cases, where the distinction between a purchase for investment and a purchase for control becomes fuzzy . . ." and, as a consequence, adopted a presumption to aid in the search for the true purpose of a purchaser. See Sutter v. Groen, 687 F.2d 197, 202 (1982).

40 Thus a true franchise in which the franchisee's profits are in large part a function of his or her own efforts will remain a nonsecurity. See, e.g., Mr. Steak, Inc. v. River City Steak, Inc. 460 F.2d 666 (10th Cir. 1972); Wieboldt v. Metz, 355 F.Supp. 255 (S.D.N.Y. 1973).
The disparate treatment seems to be justified in the Court's mind by the differing expectations of the entrepreneur in the two situations. The buyer of corporate stock contemplates the protection of the laws; the purchaser of unusual instruments does not.

Steven's dissent indicates a different attitude toward the entrepreneur who purchases stock of a corporation with the intention of managing the business. He would not extend the protection of the federal securities laws to entrepreneurs who purchase stock which is not publicly traded; however, he would extend the protection to the entrepreneur who purchases stock which is traded in a public market. Thus, under Steven's approach, entrepreneurs who purchase either unusual instruments or nonpublically traded stock would have no protection, but those who purchase publically traded stock would.41

The distinction that Stevens finds between stock which is traded in a public market and that which is not is derived from the purpose of the federal securities laws. He views that purpose as the regulation of transactions in securities which are traded in public markets.42 It is interesting that his view of the purpose of the federal securities laws seems to find support in the Court's decision in *Marine Bank v. Weaver*.43 *Weaver* involved an agreement between the guarantors of a corporation's loan and the owners of the corporation. Under the agreement, the guarantors were to receive fifty percent of the corporation's net profit and $100 per month for as long as they guaranteed the loan. In addition, they were to be permitted the use of a corporate barn and pasture at the discretion of the owners of the corporation, and were to have the right to veto future borrowing by the corporation.44 The Court held that this unique agreement, negotiated on a face-to-face, one-on-one basis and not designed to be publically traded, was not a security.45

**B. What Weight Should be Given to the Form of a Transaction?**

A second issue is what weight should be given to the form of a transaction. In several prior cases, the Supreme Court had held that the economic realities and not the form of a transaction should determine the

41 105 S. Ct. at 2313.
42 Id. at 2312.
43 455 U.S. 551 (1982).
44 Id. at 553.
45 Id. at 559-60. The decision in *Weaver* and Stevens' dissent appear to be generally consistent with the position taken in a recent article that securities are instruments which are or are capable of being the subject of transactions in a financial market. See FitzGibbon, *What is a Security? — A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980). The article is cited in *Weaver* for the proposition that the Securities Exchange Act "was adopted to restore investors' confidence in the financial markets." 455 U.S. at 555 n.4.
applicability of the federal securities laws. Many read these cases, particularly Forman, to mean that the economic reality approach should apply to corporate stock. Thus, if the transaction was in effect a purchase of assets with the intention of managing them, then the securities laws should be inapplicable.

The majority, however, interpreted its prior cases as applying the economic realities test only to "unusual instruments not easily characterized as 'securities'". It determined that, at least as to traditional stock, it would adopt a literal approach: it is a security because it is specifically enumerated in the statutory definition. The Court, however, was not willing at this time to extend its literal approach beyond traditional stock. It stated: "We here leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.'"

The decisions, then, are not likely to be of great value to lower courts in deciding what approach to adopt as to instruments other than traditional stock. In point of fact, the majority opinions may give conflicting signals to lower courts. On the one hand the Court states "... applying the Howey test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous." The Court goes on, however, to "point out several reasons why we think stock may be distinguishable from most if not all of the other categories listed in the Acts' definition." It concludes that "[u]nlike some instruments, therefore, traditional stock is more susceptible of a plain meaning approach." If the Howey test is limited to the catch-all phrases, but some enumerated instruments are not easily susceptible to a plain meaning or literal approach, what approach should be used?

The literal approach of the Court to the language in the definitional section is also somewhat surprising when viewed against the Weaver decision. In that case the Court stated "[t]he broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if 'the context otherwise requires . . . .'" The

47 See, e.g., Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981); Thompson, supra note 4.
48 Landreth, 105 S. Ct. at 2306.
49 Id.
50 Id. One reason given was that stock represents the "paradigm" of a security to many persons. This is likely to give rise to an expectation that the securities acts apply. The second reason was that stock is relatively easy to identify because its characteristics can be defined. Id.
51 Id.
52 455 U.S. at 556.
Court went on to hold that the certificate of deposit in question was not a security because of the perceived existence of adequate protections under the federal banking laws.

Prior to the Weaver decision, it was unclear whether the prefatory language referred to statutory or factual context. Weaver clearly suggested that the language permitted inquiry into the factual or economic context of a transaction in determining whether a security exists. The effect of the decisions in Landreth and Ruefenacht, however, is to preclude the examination of factual context when traditional stock is involved. Unfortunately, the Court's refusal to indicate the extent to which it would apply a literal approach to other instruments listed in the statutory definition of a security limits the guidance provided by Weaver, Landreth and Ruefenacht to the specific factual contexts before the Court in those cases.

C. How Important is a Clear and Predictable Definition?

A third issue is the relative value of a clear and predictable definition of "security" as measured against the expansion of the scope of the federal securities laws to evils which may be beyond those Congress intended to correct. The majority, while asserting its decision "comports with Congress' remedial purpose in enacting the legislation . . . ", seems to put greater emphasis on its conclusion that the sale-of-business doctrine would in many cases create slippery factual questions which would generate uncertainty as to the applicability of the federal securities laws. This uncertainty would have at least two costs. One would be the inability of the parties to a transaction to predict at the time of the transaction whether the federal securities laws were applicable. The other would be the demands placed on the federal courts which would have to ultimately resolve the complex question of control. This would often be possible only after extended discovery and litigation.

The majority in effect adopted the approach of the Second Circuit. The language of the Court sounds very much like that of the Second Circuit in Golden v. Garafalo. In Golden the majority, in rejecting the sale-of-

\[\text{See Sutter v. Groen, 687 F.2d 197, 200 (7th Cir. 1982)("The Court [in Weaver] got around seemingly uncompromising language by treating the word 'context' . . . as having reference to economic as well as linguistic context."); Banowitz v. The State Exchange Bank, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 91,997 (N.D. Ill. 1985), at 90,949 (Weaver supports focus on context of transaction instead of on literal meaning of statutory words); Thompson, supra note 4, at 251 ("The Supreme Court [in Weaver] appears to have resolved the dispute in favor of the broader approach to 'context' and against the literal approach.").}\]

\[\text{Landreth, 105 S. Ct. at 2303.}\]

\[\text{See Id. at 2307-08; Ruefenacht, 105 S. Ct. at 2310-11.}\]

\[\text{678 F.2d 1139 (2nd Cir. 1982).}\]
business doctrine, stated: "[T]he dangers of creating uncertainty as to the scope of the Acts and in generating slippery legal and factual issues going to jurisdiction are substantial." The court conceded that the rejection of the sale-of-business doctrine resulted "in a certain overbreadth in application", but viewed this as the result of a conscious legislative choice.

The Court also seems to have adopted the position of the Third Circuit in *Ruefenacht* that the costs to the public must be considered in evaluating the sale-of-business doctrine. In rejecting the sale-of-business doctrine the appellate court stated that under the doctrine:

Counsel must be hired to predict whether the purchase of a large block of stock will render it a security or a non-security. Doubts will be created over whether registrations are necessary. All of this uncertainty has real economic costs. . . . That uncertainty raises the cost of economic transactions, inhibits the flow of capital, spawns litigation, and in general benefits neither the parties or the courts.

Justice Stevens, by comparison, was more troubled by the application of the federal securities laws to transactions which he viewed as outside of the scope of congressional concern. He did not feel that the values of certainty and predictability were strong enough to justify the expansion of the securities laws to transactions involving instruments not traded in public markets.

Stevens adopts the position taken by the Seventh Circuit. In *Sutter v. Groen*, the Seventh Circuit reaffirmed its adoption of the sale-of-business doctrine stating:

The problem of drawing lines was the principal reason given by the Second Circuit in *Golden* for rejecting the sale of business doctrine. . . . We agree that the costs of administering legal rule are a proper concern in designing those rules. But rarely will a net savings in those costs be produced by expanding liability, since even if the legal standard will be simpler and therefore cheaper to apply in each case the number of potential cases in which it will be applied will be greater. And if there were some net savings we doubt they could justify expanding liability to

57 *Id.* at 1146.
58 *Id.* Cf. *Dillport, Restoring Balance to the Definition of a Security*, 10 SEC. REG. L.J. 99, 121 (1982) ("The orderly administration of the Acts will become unmanageable . . . if the status of an instrument as a security is determined on the basis of the transaction in which it transferred.").
59 737 F.2d at 332.
60 *Id.* at 332-33.
61 687 F.2d 197 (7th Cir. 1982).
reach substantive evil far outside the scope of the legislature's concern.\textsuperscript{62}

The majority's concern in \textit{Landreth} and \textit{Ruefenacht} that the definition of "security" be certain and predictable seems somewhat out of step with the Court's decision in \textit{Weaver}, which placed great emphasis on the context of a transaction. The decision in \textit{Weaver}, fairly read, would seem to encourage the case-by-case analysis that both \textit{Landreth} and \textit{Ruefenacht} reject. In \textit{Weaver}, after deciding that the certificate of deposit and the business agreement involved were not securities, the Court stated in a footnote:

\begin{quote}
It does not follow that a certificate of deposit or business agreement . . . invariably falls outside the definition of a "security" . . . . Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.\textsuperscript{63}
\end{quote}

One could argue that Stevens' dissent is more consistent with the decision in \textit{Weaver}.

\textbf{D. When Should Need for Protection be a Factor?}

A fourth issue is the extent to which need for protection should be a factor in determining whether a security exists. The majority dealt with this issue obliquely. It noted that traditional stock "represents to many people, both trained and untrained in business matters, the paradigm of a security."\textsuperscript{64} The Court continued: "[P]ersons trading in traditional stock likely have a high expectation that their activities are governed by the Acts."\textsuperscript{65} The Court also posited that the uncertainty generated by the

\begin{footnotesize}
\textsuperscript{62} Id. at 202. One judge, referring to the adoption of the sale-of-business in the Second Circuit, has stated:

our district courts will soon be burdened with an escalating stream of cases where purchasers of businesses have become disillusioned with bargains they made. . . . Here the parties involved are relatively sophisticated businessmen who contracted to purchase a business in order to control its operation themselves. There is no good reason why federal courts should hear such cases and permit such a totally unnecessary expansion of federal jurisdiction. To do so seems to disregard all that we are constantly told by our brethren on the Supreme Court, and that we ourselves know, about the overworked federal judicial system.


\textsuperscript{63} 455 U.S. at 560 n.11.

\textsuperscript{64} \textit{Landreth}, 105 S. Ct. at 2306, quoting Daily v. Morgan, 701 F.2d 496, 500 (5th Cir. 1983).

\textsuperscript{65} 105 S. Ct. at 2306.
\end{footnotesize}
sale-of-business doctrine does not permit "the purchaser to compensate for the added risk of no protection when negotiating the transaction."66

The Court sought to protect the expectations of corporate stock purchasers that the federal securities laws apply to the transaction because these purchasers will rarely seek other protections.

Justice Stevens approaches in a more direct manner the question of need for protection. He argues that a purchaser of stock which is not publically traded should not be entitled to the protections of the antifraud provisions of the federal securities laws if he or she is in a position to negotiate appropriate contractual warranties or insist on access to inside information prior to consummating transaction.67 Interestingly enough, it appears that he would apply the antifraud provisions of such laws to stocks which were not publically traded if the purchaser were not in a position to so protect himself or herself. This is extremely difficult to square with Stevens' view of the securities laws as intended to regulate transactions in public markets. Stevens' willingness to apply the federal securities laws in this situation may be based on the purchaser's need for protection or on the investor as opposed to entrepreneurial status of the purchaser. It is not entirely clear which of the two considerations is predominant.

The Court's treatment of the issue of need for protection is interesting for a number of reasons. First, the Court seems to find a need for protection based on the expectation of a party that the securities laws would be applicable. It would be legitimate to query, however, whether such an expectation should be significant. One author has stated:

Even assuming that the buyer expects the securities laws to apply to the sale of stock, it is unfair to bind the seller to these expectations unless the buyer's expectations are reasonable. This, in turn, depends on whether the transaction is one to which the securities laws were intended to apply.68

Secondly, the Court's decision may be somewhat surprising in light of its prior decisions. Lack of a need for the protections of the federal securities laws seems to have been a factor in each of the Court's last three decisions dealing with the question of whether a security existed. In United Housing Foundation v. Forman69 the Court found that shares of stock in a non-profit housing cooperative were not securities. In a footnote

66 Ruefenacht, 105 S. Ct. at 2311.
67 105 S. Ct. at 2313.
68 Ribstein, Securities Regulation, 34 MERCER L. REV. 1461, 1484 (1983). Ribstein concludes that the sale of assets is not a securities transfer and that "[i]t is . . . difficult to understand why it should matter whether a transfer of all the assets of a business is structured as a sale of 'assets' or of 'stock'". Id. at 1484.
to the case the Court opined that the purchasers took "no risk in any significant sense." As evidence, the Court noted the fact that the state was financing the bulk of the construction costs and was regulating the "development and operation of the project."\(^{70}\) In *International Brotherhood of Teamsters v. Daniel*,\(^{71}\) the Court held that a compulsory, noncontributory pension plan did not constitute a security. The Court noted the passage of the Employee Retirement Income Security Act of 1974 as a factor supporting its decision. It stated:

> The existence of this comprehensive legislation governing the use of terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans. Congress believed that it was filling a regulatory void when it enacted ERISA. . . . Not only is the extension of the Securities Acts by the court below unsupported by the language and history of those Acts, but in light of ERISA it serves no general purpose.\(^{72}\)

In *Marine Bank v. Weaver*\(^{73}\) the Court held that an insured certificate of deposit issued by a federally regulated bank and a privately negotiated agreement were not securities. As to the certificate of deposit, the Court noted that it "was issued by a federally regulated bank which is subject to the comprehensive set of regulations governing the bank industry."\(^{74}\) The Court also pointed out that "deposits [in federally regulated banks] are insured by the Federal Deposit Insurance Corporation. Since its formation in 1933, nearly all depositors in failing banks insured by the FDIC have received payment in full, even payment for the portions of their deposits above the amount insured."\(^{75}\) The Court concluded: "It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws."\(^{76}\) As to the privately negotiated agreement, the Court noted, among other things, that "the provision that the Weavers could veto future loans gave them a measure of control over the operation of the slaughterhouse not characteristic of a security."\(^{77}\) Presumably this control over the operation of the business was significant because it

\(^{70}\) *Id.* at 857 n.24.

\(^{71}\) 439 U.S. 551 (1979).

\(^{72}\) *Id.* at 569-70.

\(^{73}\) 455 U.S. 551 (1982).

\(^{74}\) *Id.* at 558.

\(^{75}\) *Id.*

\(^{76}\) *Id.* at 559.

\(^{77}\) *Id.* at 560.
reduced the Weaver’s need for the protections of the federal securities laws.\textsuperscript{78}

The Supreme Court’s rejection of the sale-of-business doctrine is arguably inconsistent with its decision in \textit{Weaver}. In fact, prior to \textit{Landreth} and \textit{Ruefenacht} one author had suggested that “the Supreme Court would decide that a one-on-one negotiated sale of a business through a stock transfer is not a security” because of the existence of other adequate protections in that situation. These were perceived to include “(1) the presence of an attorney at the negotiations; (2) contractual warranties; and (3) state antifraud laws”.\textsuperscript{79}

It is possible that the Supreme Court’s rejection of the sale-of-business doctrine was an attempt to rectify an error it perceived in the \textit{Weaver} decision. The suggestion in \textit{Weaver} that the Court would not apply the federal securities laws to unusual, privately negotiated transactions was criticized as “erroneously equat[ing] the registration provisions of the federal securities laws with the anti-fraud provisions of those laws.”\textsuperscript{80} It is interesting to note that in the \textit{Landreth} opinion the Court expressly states that: “although § 4(2) of the 1933 Act . . . exempts involving any public offering from the Act’s registration provisions, there is no comparable exemption from the antifraud provisions.”\textsuperscript{81} Perhaps, then, the Court felt it made a mistake in \textit{Weaver} and attempted to correct it in \textit{Landreth}.

\textbf{E. Is a Security a Thing or a Transaction?}

A final issue is whether something can be a security as to one person and not as to another. The sale-of-business doctrine assumes that this is the case. Some courts and commentators have found very troubling the suggestion that something might be a security as to one person and not as to another.\textsuperscript{82}

\textsuperscript{78} Cf. Coffey, \textit{The Economic Realities of a “Security”: Is There a More Meaningful Formula?}, 18 W. Res. L. Rev. 367, 396 (1967) (“The danger of fraud being practiced on the buyer is considerably reduced when his initial investment is subjected to risks of an enterprise with which he is familiar at the time of the transaction and over which he exercises management control.”) One can question whether the measure of control given by the veto was substantial enough to provide significant protection. \textit{Compare} Schultz v. Dain Corp., 568 F.2d 612 (8th Cir. 1978) (purchase of apartment complex and contemporaneous management contract not a security; purchaser retained ultimate control over complex).


\textsuperscript{81} \textit{Landreth}, 105 S. Ct. 2305.

\textsuperscript{82} One author has written that “courts upholding the sale of business doctrine have
The majority, while not stating that the identity or characteristics of the parties is always irrelevant to security status, stated:

Application of the sale of business doctrine would also lead to arbitrary distinctions between transactions covered by the Acts and those that are not. Because applicability of the Acts would depend on factors other than the type and characteristics of the instrument involved, a corporation’s stock could be determined to be a security as to the seller, but not as to the purchaser, or as to some purchasers but not others. . . . Such distinctions make little sense in view of the Acts’ purpose to protect investors.83

The Court’s description of the possibility under the sale-of-business doctrine that stock would be a security as to one person and not as to another as being arbitrary and “depending on factors other than the type and characteristics of the instrument involved” seems to evince a view that a security is a thing and not a transaction. The Court suggests that a thing must be a security as to all or as to none. It can’t be a security as to some.

Justice Stevens did not expressly address this issue. It seems clear, however, that he would find the same interest could be a security as to some but not as to others. He would hold that the federal securities laws are inapplicable to a purchase of corporate stock that is not publically traded unless the purchaser is an investor without the ability to negotiate contractual protections or demand access to inside information. This distinction between who is and who is not protected by the federal securities laws is based on factors which may well be extrinsic to the characteristics of the interest transferred.

If it is the view of the Court that something must be a security as to all or as to none, then a number of lower court cases not involving the sale-of-business doctrine, such as Williamson v. Tucker84 and other

introduced a disconcerting asymmetry into securities transactions in that one party may be dealing in a security while the other is not.” Karjala, supra note 4, at 429. See also Darrell, supra note 79, at 53 (“Shares of stock, unlike lizards, are not chameleons. Just as a leopard cannot change its spots, an instrument cannot change its status as a security depending on who holds it.”). Compare Seldin, supra note 4, at 681 n. 107 (“strangeness of this result is largely superficial”).

In one recent case, a federal district court responded to the argument that a certificate of deposit was a security as to a bank’s auditors even if it was a nonsecurity as to the bank by stating: “[The purchaser] may be able to allege that it purchased a car with no motor and that the seller was a crook, but it cannot show that the car it purchased was ‘in effect’ a bicycle.” Brockton Savings Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281, 1286-87 (1983).

83 Ruefenacht, 105 S. Ct. at 2311.
similar decisions, are wrong. The court in *Williamson*, for example, stated that an interest in a general partnership or joint venture could be a security in a number of situations including where the "partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers." It is clear that the court in *Williamson* would permit inquiry into the characteristics of the purchaser of a general partnership interest as well as the characteristics of the interest itself. A general partnership interest sold to a sufficiently unsophisticated investor might be a security; a similar interest sold to an experienced businessperson would not be. The appropriateness of such an approach is in substantial doubt after *Landreth* and *Ruefenacht*, in spite of the fact that *Weaver* seems to encourage examination of factual context.

III. Conclusion

In evaluating the recent decisions in *Landreth* and *Ruefenacht* one could ask two questions: (i) What do the decisions tell us? and (ii) What questions are not answered by the decisions?

The decisions clearly answer the question of the validity of the sale-of-business doctrine. It is not valid. Traditional common stock is a security simply because it is stock. In a given case it would still be open to a party to present evidence that the instrument involved was not stock.

---


86 645 F.2d at 424.

87 On the other hand, is there a difference between corporate stock and investment contracts so that while corporate stock is always a security, other instruments may be or may not be investment contracts depending upon the characteristics of the holder? The Fifth Circuit, which had rejected the sale-of-business doctrine, recently stated:

it is not necessary that an interest be deemed a security in the hands of both the seller and the purchaser.

The characterization of an interest as a security or not can vary with the relationship of its holder to the venture. If the interest takes the form of an investment contract, *Howey* teaches that it is a security only if the holder is relying on the managerial skills of others to generate his profit. By implication, if the holder is relying on his own entrepreneurial talents to generate his profit, his interest is not treated as a security because he does not fall within the class of persons Congress meant to protect when it included non-traditional securities in the coverage of the securities laws.

This is permitted by the *Forman* decision. However, if the instrument has the characteristics usually associated with common stock, there is no longer room for argument as to the applicability of the federal securities laws.

Unfortunately, however, while we now know that the Court will apply the *Howey* test to investment contracts and a literal or plain meaning approach to corporate stock, we do not know what approach it would apply to other types of instruments which are enumerated in the statutory definitions.

The decisions also indicate a concern on the Court's part that the definition of a security be as clear as possible and that the applicability of the federal securities laws be predictable at the time of a transaction. The Court states candidly that "[i]t is fair to say that our cases have not been entirely clear on the proper method of analysis for determining whether an instrument is a 'security.'" 88

The Court's concern that the definition of "security" be certain and predictable is admirable. Many commentators have lamented the continuing confusion over the appropriate definition of this important term. 89 It would be fair to ask, however, whether the *Landreth* and *Ruefenacht* cases clarify anything other than the appropriate treatment of traditional stock. The narrow basis upon which the Court decided the cases coupled with the apparent inconsistencies of the Court's approach with prior decisions limit the guidance of the decisions to sales of traditional stock. They are unlikely to be of much value in other contexts.

---

88 *Landreth*, 105 S. Ct. at 2303.
89 See Karjala, supra note 4, at 437 ("Securities law affects thousands of transactions every day. . . . The difficulties posed by unclear and unpredictable rules and case law need not be elaborated."); *Newton*, *What is a Security?: A Critical Analysis*, 48 Miss. L.J. 167 (1977) ("Over forty years after the adoption of the [federal securities acts], the controversy surrounding what constitutes a security still rages. . . . [F]rom the pragmatic viewpoint of counsel whose client proposes to raise funds by a public offering, this matter demands clarity, not confusion.")