1985

When Is a Car a Bicycle and Other Riddles: The Definition of a Security under the Federal Securities Laws

M. Thomas Arnold
University of Tulsa College of Law

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

Part of the Securities Law Commons

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

Recommended Citation

This Article is brought to you for free and open access by the Law Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized administrator of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.
“WHEN IS A CAR A BICYCLE?” AND OTHER RIDDLES: THE DEFINITION OF A SECURITY UNDER THE FEDERAL SECURITIES LAWS

M. Thomas Arnold*

I. INTRODUCTION ......................................... 449
II. THE Howey TEST: A QUESTION OF INTERPRETATION ........................................ 451
III. RECENT SUPREME COURT CASES: THE SEARCH FOR A DEFINITION OF “SECURITY” CONTINUES ........................................ 454
A. The Forman and Daniel Decisions ........................................ 454
B. Marine Bank v. Weaver ........................................ 457
   1. A Brief Summary of the Case ........................................ 457
   2. Discussion of the Case ........................................ 459
IV. POST Weaver CERTIFICATE-OF-DEPOSIT CASES ........................................ 463
A. Wolf ........................................ 463
   1. The District Court Decision ........................................ 463
   2. The Court of Appeals Decision ........................................ 470
B. Brockton ........................................ 471
V. JUDICIAL DISAGREEMENT ON OVERRIDING QUESTIONS OF POLICY: A CONTRIBUTING FACTOR IN THE CONFUSION ........................................ 477
VI. Is There Any Hope? ........................................ 483
VII. CONCLUSION .............................................. 489

I. INTRODUCTION

In Marine Bank v. Weaver,¹ the United States Supreme Court decided that a certificate of deposit purchased from a federally-regulated bank was not, under the circumstances of the case, a security under federal laws. Several recent federal court cases have considered the question of the status of certificates of deposit under factual circumstances somewhat different from Weaver. Two of these cases provide an interesting study of the uncertainty that continues to surround the definition of a security.²

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

¹ 455 U.S. 551 (1982).

The definitions of "security" found in the Securities Act of 1933 and the Securities Exchange Act of 1934 are very similar; therefore, any interpretation of the term under one Act carries substantial weight in interpreting the term for the purposes of the other. In addition, the defini-

case the court, citing Weaver, 455 U.S. 551, held that the plaintiff's allegation of fraud was unfounded in fact and that a certificate of deposit issued by an "American banking institution" such as those involved in the case was not a security. The court stated that the "ingenious argument that the 'CD Program' itself, as distinguished from the certificates of deposit themselves, is a "security" will not withstand scrutiny . . . . A program to sell a nonsecurity cannot become a security absent an appellate pronouncement to the contrary." Id. at 98, 444. Rapp, The Role of Promotional Characteristics in Determining the Existence of a Security, 9 SEC. REG. L.J. 26 (1981)(arguing that the way in which an interest is promoted may be a factor in the determination of whether a security exists).

Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1)(1982). The definition is:
When used in this subchapter, unless the context otherwise requires
(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

When used in this chapter, unless the context otherwise requires
(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.


Weaver, 455 U.S. at 555 n.3. ("We have consistently held that the definition of 'security' in the 1934 Act is essentially the same as the definition of 'security' in . . . . the Securities Act of 1933 . . . . "). Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967)("The Securities Act of 1933 . . . . contains a definition of security virtually identical to that contained in the 1934 Act. Consequently, we are aided in our task by our prior decisions which have considered the meaning of security under the 1933 Act."). For a table setting forth a side-by-side
DEFINITION OF A SECURITY

sections of "security" under these two federal schemes are similar to the definition found in the Uniform Securities Act. Thus, "[w]hile there are some differences, the basic definition of a security under the Securities Act, the Exchange Act, and state blue sky laws is the same."7

Despite the lengthy definitions of "security" found in federal securities laws, much uncertainty remains as to exactly what is included within the concept of a security.8 This state of affairs is unacceptable given the importance of the issue to the business community and its legal counselors.9

This Article will discuss briefly the well-known Howey test and several questions regarding its interpretation. This Article will then address the three most recent Supreme Court cases dealing with the definition of "security" under the federal securities laws and show that these cases either have continued or compounded the confusion over the definition. The two post-Weaver certificate-of-deposit cases will then be examined in an effort to demonstrate the uncertainty which remains concerning the status of certificates of deposit under the federal securities laws. This Article will then conclude with a discussion of the confusion that has resulted due to judicial disagreement as to overriding policy and will propose that decisive action by the Supreme Court is necessary to bring some clarity and certainty to this important area of the law.

II. THE HOWEY TEST: A QUESTION OF INTERPRETATION

The term "security" has long been accorded a broad interpretation by both federal and state courts.10 In particular, the catch-all phrase "invest-


6 Section 401(1) of the Uniform Securities Act. This similarity is not mere coincidence. The Commissioners' Note to this section indicates that it is based on § 2(1) of the Securities Act of 1933. 7A Uniform Laws Ann. 631 (1978).


8 See Hannan & Thomas, supra note 5, at 219 ("The definition of the term 'security,' as used in the principal federal securities laws, is for the most part one of the best kept secrets in recent legal history.").

9 See infra note 197.

10 One commentator has stated: "Indeed, perhaps the day is not far hence when it will be said of the securities laws as it has been similarly said of heaven, the Internal Revenue Code, and the antitrust statutes that 'not a sparrow falls without the securities laws nodding their assent.'" Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?, 18 W. Res. L. Rev. 367, 368 n.9 (1967). Cf. Newton, What is a Security?: A Critical Analysis, 48 Miss. L.J. 167, 199 (1977)("investments once thought to fall beyond the
ment contract," found in the definition of "security" under both federal and state law, has been utilized to fulfill the remedial purposes of the federal and state acts. The Supreme Court has stated:

[The reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"]

In the landmark Supreme Court case *S.E.C. v. W.J. Howey Co.*, the now-famous Howey test was born. State courts, as well as federal courts, have looked to this test to determine whether a particular interest constitutes a security: "[The question is] whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

For courts employing the Howey test, a number of questions of interpretation have arisen. For example, the test speaks of profits coming solely from the efforts of others. Read literally, this element of the test would exclude any interest in a venture in which the efforts of the investor contributed to the profit earned. Recognizing this, a number of decisions have held that "solely" does not really mean "solely." The best known decision in this area is *S.E.C. v. Glenn Turner Enterprises*, where the Ninth Circuit held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract." The court realized that if the requirement were read in a mechanical fashion, it "would be easy to evade by adding a requirement that the securities provisions have been absorbed into the securities categorization, often to the amazement of newcomers to the securities bar"). In the last ten years, however, the Supreme Court has decided three cases involving the question of whether a security existed. In all three it found that the instrument in question was not a security. Marine Bank v. Weaver, 455 U.S. 551 (1982); International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979); United Housing Found. v. Forman, 421 U.S. 837 (1975). Cf. Dillport, *Restoring Balance to the Definition of a Security*, 10 Sec. Reg. L.J. 99 (1982)("Commentators on the scope of the definition of the term 'security' . . . once discussed its expanding concept. In recent years, however, the lower federal courts have narrowed the scope of the definition.").

---

12 328 U.S. 293 (1946).
14 328 U.S. at 301.
15 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).
16 474 F.2d at 482.
DEFINITION OF A SECURITY

buyer contribute a modicum of effort." The court found that the remedial aims of the securities laws could best be served by adopting a "more realistic test, [one which examines] whether the efforts made by those other than the investor are the undeniably significant ones, those essential efforts which affect the failure or success of the enterprise." Under this rationale, an investor may contribute his input, but it must be non-investors who make crucial managerial decisions.

Another question of interpretation has involved the meaning of the "common enterprise" requirement. Several courts have interpreted the commonality element of the Howey test to require multiple investors and a pro rata distribution of profits. Other courts have rejected this horizontal commonality; rather, these courts have viewed the "common enterprise" element as requiring nothing more than the intertwining of the fortunes of the investor with the efforts of either those seeking the investment or of other third parties. This more inclusive approach accepts as

17 Id.
18 Id. Did the Supreme Court, in United Housing Found., Inc., v. Forman, 421 U.S. 837 (1975), acquiesce to this interpretation of the Howey test? It has been noted that the Court left the word "solely" out of its formulation of the definition of investment contract in that case. Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir.), cert. denied, 454 U.S. 897 (1981). The Turner decision has been analyzed by one author as a possible reaction by the Ninth Circuit to the facts of the case before it:

Witness this sentence from the first paragraph of the court's opinion: "The trial court's findings, which are fully supported by the record, demonstrate that defendants' scheme is a gigantic and successful fraud." Unfortunately that case, and others like it, may be demonstrating the truth of the old maxim that hard cases make bad law.

20 The requirement of multiple investors has been criticized on the grounds that "it makes no sense to penalize the single investor simply because he happens to be alone in his misfortune." Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981). On the other hand, it has been suggested that the Supreme Court in Weaver rejected by implication the position that commonality can exist in single investor situations. See Note, Securities Regulation Incident to Certificates of Deposit and Privately Negotiated Agreements: Departures From a Functionally Operative Definition, 62 NEw. L. REV. 579, 598 (1983); First National Bank & Trust Co. v. Thoele, 1982 Fed. Sec. L. REP. (CCH) ¶ 99,854 (W.D. Okla. 1982)("this court must hold that vertical commonality between a single investor and promoter does not satisfy the common enterprise element of an investment contract." Id. at ¶ 94,408).
21 See, e.g., S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 521-22 (5th Cir. 1974). Some courts have held that it is not enough that the investor's fortune be dependent upon the efforts of others. These courts, while not requiring multiple investors, have required a correlation between the success or failure of the promoter or third party and the success or failure of the investor. Thus, if the promoter or third party can prosper while the investor fails, there is no vertical commonality. See Mordaunt v. Incomco, 688 F.2d 815 (9th Cir. 1982), cert. denied, ___ U.S. ___, 105 S. Ct. 801 (1985); Brodt v. Bache & Co. 595 F.2d 459 (9th Cir. 1978).
sufficient either horizontal or vertical commonality.

A third unresolved question is whether the Howey test is to be applied only to help courts identify "the somewhat elusive investment contract,"22 or whether it is an all-inclusive test to be applied even to less elusive types of securities, such as corporate stock; on this point there is vigorous debate. The resolution of this issue will affect the validity of the sale-of-business doctrine, discussed below23 in connection with United Housing Foundation v. Forman.24

The Howey test has provided a basic framework for the determination of whether many different instruments or transactions invoke the securities laws. Questions of interpretation that have arisen in the lower courts generally have been resolved through an analysis of the perceived purposes of the securities laws.

III. RECENT SUPREME COURT CASES: THE SEARCH FOR A DEFINITION OF "SECURITY" CONTINUES

A. The Forman and Daniel Decisions

In recent years, the Supreme Court has considered several cases involving the issue of what constitutes a security.25 In United Housing Foundation, Inc. v. Forman,26 the Court found that shares of stock in a non-profit housing cooperative were not securities. The shares had entitled the shareholder to lease an apartment in the cooperative and were non-transferable, descending only to a surviving spouse. In part I of its decision, the Court rejected the notion that the purchased interest must be considered a "security" simply because it was labeled "stock," and the statutory definition of "security" includes the word "stock."27 The Court stated that "[b]ecause securities transactions are economic in character Congress intended the application of the statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."28 The Court pointed out that the shares involved had none of the characteristics commonly associated with a security.29

In part II of its decision, the Court rejected the contention that a share of stock in the cooperative constituted an "investment contract." Applying the Howey test, the Court stated that "there can be no doubt that

23 See infra text accompanying notes 31-35.
24 See supra note 10.
25 See supra note 10.
27 Id. at 848.
28 Id. at 849. Still, "[a] share of stock will almost always be deemed to be a 'security.'"
29 D. RATNER, SECURITIES REGULATIONS IN A NUTSHELL 23 (2d ed. 1982).
20 421 U.S. at 851.
DEFINITION OF A SECURITY

investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments."

The Forman decision, like that in Howey, has generated conflicting interpretations. Perhaps most significantly, courts and commentators have been unable to agree on whether Forman authorizes application of the Howey test to corporate stock. Those that believe that it does focus in part on the following statement made by the Court: "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 word 'any . . . stock.'" Others reject this interpretation, alleging instead that the Forman Court applied the Howey test only after deciding, in effect, that the shares involved in the case were not really stock. Such a theory was adopted by the Second Circuit: "Having first determined that the . . . shares were not stock, the Court went on to determine whether they were an 'investment contract.'"

This argument is, in reality, part of a larger conflict, to wit, whether the Howey test is a general test which all securities must meet, or whether it merely defines the catch-all term "investment contract," so that there are "securities" that do not meet the requirements set out in the test. Commentators remain hopelessly divided on the issue.

In a second recent decision, International Brotherhood of Teamsters v. Daniel, the Supreme Court held that a compulsory, noncontributory pension plan did not constitute a "security" under federal security laws. The Court stated that the test of whether a financial relationship constitutes an "investment contract" is the Howey test; however, "[t]his test is to be applied in light of the 'substance—the economic realities of the transaction—rather than the names that may have been employed by the parties.'"

30 Id. at 853.
32 421 U.S. at 848.
34 Golden v. Garafolo, 678 F.2d 1139, 1144 (2d Cir. 1982).
37 Id. at 558.
38 Id. (quoting United Housing Found., Inc. v. Forman, 421 U.S. 837, 85-152 (1975)).
Applying the Howey test to the facts of this case, the Court found first that there was no investment of money\(^9\) and, second, that there was no expectation of profit from a common enterprise.\(^4\) The Court rejected the plaintiff-employee's argument that by allowing part of his compensation to be paid into it, he had invested in the compulsory pension fund. "[T]he purported investment [was] a relatively insignificant part of [the] employee's total and indivisible compensation package,"\(^41\) the "decision to accept and retain covered employment must have only an attenuated relationship, if any, to perceived investment possibilities of a future pension."\(^42\) In addition, under this pension plan, the eligibility of an employee depended primarily on whether the employee met the vesting requirements.\(^43\) Thus, any "profit" expected by an employee would be a result of his or her own efforts rather than on the managerial efforts of the trustee.\(^44\)

After applying a Howey analysis and noting the passage of the Employee Retirement Security Act of 1974\(^46\) in part IV of its opinion,\(^46\) the Court addressed the effect of this legislation on the characterization of the Daniel pension plan:

The existence of this comprehensive legislation governing the use and 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.\(^47\)

---

\(^9\) 439 U.S. at 559-61.
\(^4\) 439 U.S. at 561-62.
\(^1\) Id. at 560. The Court noted, however, that it was not deciding that a person must invest money, rather than property or services. Id. at n.12. The Court was simply unwilling to allocate part of the labor, on the facts of the case, as consideration for the pension. Id. at 560.

\(^41\) Id. at 560. Was the Court's conclusion factually correct? Cf. Carney & Fraser, Defining a "Security": Georgia's Struggle With the "Risk Capital" Test, 30 Emory L.J. 73, 98 (1981), wherein the authors state: "The opinion [in Daniel] ignores the 'economic reality' that pension plans have become the dominant mode of savings for many Americans, and funneling investments through such institutions has grown tremendously in popularity over the years."

\(^42\) 439 U.S. at 562.

\(^4\) Id.


\(^46\) 439 U.S. at 569-70.

\(^47\) Id. Cf. Carney & Fraser, supra note 42, at 75-76, where the authors note: The ultimate difficulty in defining a security is, of course, that promoters offer a continuum of opportunities to the public . . . and there is no bright and clear line to be drawn. In order to draw any line one must examine the justifying aim of securities regulation, both in terms of the evil to be prevented and the skills of the
This theme, introduced in Daniel as an afterthought, was to reappear in the Weaver opinion.

After Forman and Daniel, the definition of "security" remained unresolved. One author stated that "the door [was] still open to the development of basic principles in [the] area . . . ."48

B. Marine Bank v. Weaver

1. A Brief Summary of the Case

The most recent Supreme Court decision on the definition of the term "security" did little, if anything, to resolve the open questions. In fact, more questions may have been raised than answered.

*Marine Bank v. Weaver*49 involved a couple who purchased a $50,000 certificate of deposit from a bank. They then pledged the certificate, which was partially insured by the Federal Deposit Insurance Corporation (FDIC), to the same bank to guarantee a $65,000 loan by the bank to third parties. The *quid pro quo* for the loan guarantee was an agreement between the owners of the certificate and the third parties whereby the certificate owners were to receive fifty percent of the net profits of the third parties' business and one hundred dollars per month for the duration of the guarantee. In addition, the certificate owners were given the right to veto future borrowing by the business and were given the use of a barn and pasture owned by the business.60

When the business subsequently filed for bankruptcy, the bank indicated its intention of claiming the pledged certificate of deposit. The certificate owners then filed suit against the bank alleging, among other things, a violation of section 10(b) of the Securities Exchange Act. They claimed that the bank officers had represented that the proceeds of the loan that they were guaranteeing would be used by the business as working capital; instead, the money was used in large part to repay prior bank
loans and cover an overdrawn checking account. Additionally, it was alleged that the bank officers were aware of, but did not disclose, the poor financial condition of the business.\textsuperscript{81}

The district court granted a motion for summary judgment filed by the bank on the section 10(b) claim on the basis that "if a wrong occurred it did not take place 'in connection with the purchase or sale of any security,' as required for liability . . . ."\textsuperscript{82} The court of appeals reversed, holding that either the certificate of deposit or the contract between the certificate owners and third parties reasonably could be found to be a security.\textsuperscript{83}

The decision of the court of appeals was reversed by the Supreme Court. While recognizing that the definition of "security" under the Securities Exchange Act of 1934 is broad and that the term has been interpreted in an expansive manner, the Court stated: The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if 'the context otherwise requires . . . .' Moreover, we are satisfied that Congress, in enacting securities laws, did not intend to provide a broad federal remedy for all fraud.\textsuperscript{84}

The Court held, first, that the certificate of deposit was not a security; bank certificates of deposit are significantly different from other long-term obligations. The certificate of deposit in question "was issued by a federally regulated bank which is subject to the comprehensive set of regulations governing the bank industry."\textsuperscript{85} The Court then noted 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 FDIC have received payment in full, even payment for the portions of their deposits above the amount insured."\textsuperscript{86}

These considerations led the Court to conclude:

The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires. 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. We therefore hold that the certificate of deposit [involved] is not a security.\textsuperscript{87}

\textsuperscript{81} Id. at 553-54.
\textsuperscript{82} Id. at 554.
\textsuperscript{83} Id.
\textsuperscript{84} Id. at 555-56.
\textsuperscript{85} Id. at 557-58.
\textsuperscript{86} Id. at 558.
\textsuperscript{87} Id. at 558-59. The Court's comments were made prior to the collapse of the Penn Square Bank. The amount of uninsured deposits at Penn Square has been estimated to be
The Court also held that the agreement between the certificate owners and the third parties was not a security. The agreement was "not the type of instrument that comes to mind when the term security is used."

According to the Court:

The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case. In Howey, for example, 42 persons purchased interests in a citrus grove during a four-month period. In C.M. Joiner Leasing, offers to sell oil leases were sent to over 1,000 prospects. In C.M. Joiner Leasing, we noted that a security is an instrument in which there is "common trading." The instruments involved in C.M. Joiner Leasing and Howey had equivalent values to most persons and could have been traded publically.

By comparison, the certificate of deposit owners and the third parties in Weaver had negotiated a "one-on-one" unique agreement "not designed to be traded publically."

Finally, the Court noted in passing 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."

The Court's holding in Weaver was, however, expressly limited to the facts of the case. The final footnote to the opinion stated:

It does not follow a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a security as defined by the federal statutes. 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.

2. Discussion of the Case

The decision in Weaver is interesting in several respects. First, the Court based its decision on the "context otherwise requires" language preceding the statutory definitional section. The Court delineated in gen-

---

58 455 U.S. at 559.
59 Id. at 559-60 [citation omitted].
60 Id. at 560.
61 Id.
62 Id. at n.11.
eral terms two factual situations in which the context did not require a finding of a security and application of federal security laws. Before the *Weaver* decision there had been significant discussion as to whether the “context otherwise requires” language referred to statutory context or factual context.63 The *Weaver* decision seems to support the position that the prefatory “context otherwise requires” language permits inquiry into the factual context in which the subject transaction arises.64

Second, while the Court mentioned the *Howey* case, it did not engage in a *Howey*-type analysis of the status of the certificate of deposit. Rather, it focused primarily on a perceived lack of need for application of the antifraud provisions of the federal securities laws. What makes this approach intriguing is that a number of previous lower federal and state court decisions perhaps can be best explained as attempts to use the securities laws to fashion remedies where other remedies may have been inadequate or nonexistent.65 *Weaver* can be viewed as the negative image

---

63 See Thompson, *supra* note 31, at 250-51:
Some courts have viewed this phrase as express statutory authority to reject a literal interpretation of the coverage of the federal securities laws. They have interpreted the term “context” as referring to the “surrounding factual circumstances: and have analyzed the particular transaction to determine whether it evinces characteristics common to security transactions. Other courts have taken a more limited view of the prefatory language, construing the term “context” as referring to the “statutory context” that is, the definition of a term within the Act may vary from one section to another.

64 Sutter v. Groen, 687 F.2d 197, 200 (7th Cir. 1982)(“The Court [in *Weaver*] got around seemingly uncompromising statutory language by treating the word ‘context’ . . . as having reference to economic as well as linguistic context.”); Thompson, *supra* note 31, at 251 (“the Supreme Court [in *Weaver*] appears to have resolved this dispute in favor of the broader approach to ‘context’ and against the literal approach.”). But cf. Ruefenacht v. O’Halloran, 737 F.2d 320, 322 (3d Cir.), cert. granted sub nom. Gould v. Ruefenacht, ___ U.S. ___, 105 S. Ct. 428 (1984)(post *Weaver* decision that appears to cling to statutory context interpretation). The author of one recent article presents a persuasive case that the *Weaver* Court’s conclusion is incorrect. See Bunch, *Marine Bank v. Weaver: What is a Security?*, 34 MERCER L. REV. 1017, 1036-37 (1983).

65 Cf. D. RATNER, SECURITIES REGULATION IN A NUTSHELL 26 (2d ed. 1982):
These terms [“investment contract” and “certificate of interest or participation in any profit-sharing agreement”] have been liberally interpreted by the courts to apply to a wide range of schemes, particularly where the SEC or state regulators have sought injunctions against activities for which there was no prompt effective relief available under other laws designed to protect the public. See also Schneider, *The Elusive Definition of a “Security,”* 14 REV. SEC. REG. 981, 982-83 (1981). Schneider states:
As a practical matter, it is likely that the inadequacy of disclosures or the existence of fraud affecting the transaction will militate towards the finding of a “security.” For example, fraud tainting the offering seems to have influenced courts in the context of pyramid sales and multilevel distributorship programs. . . . Inevitably, courts seem to be result-oriented and are influenced by whom is suing whom for what. For example, if a sophisticated party is trying to disaffirm his or its own commitment by invoking the securities laws, such party is less likely to
of these cases; it denied application of the securities laws because other federal remedies and safeguards were deemed adequate. The Court's approach is reminiscent of part IV of the Daniel opinion. In Daniel, however, the Court spoke of the lack of need for application of the federal securities laws only after applying the Howey test to the facts of the case. The Weaver Court fails to explain why it eschewed a Howey analysis. Two possible explanations come to mind. The Justices may have believed that such an endeavor was unnecessary because the lack of need for application of the federal securities laws was determinative. If this is true, then an instrument that satisfies the elements of the Howey test could still fail to be a security if there were no perceived need for application of federal securities laws. On the other hand, the Court may have entertained an unarticulated belief that the Howey test is not applicable to debt (as opposed to equity) instruments.

Third, while the Court emphasized the protections afforded by federal banking regulations in determining that the certificate of deposit was not a security, several commentators have pointed out that those regulations afforded no protection against the wrong alleged by the Weavers, i.e., having the certificate of deposit wrongfully taken from them. In addition, the Court failed to consider whether federal banking regulations and federal securities laws address the same evils or pursue different goals.

A final interesting aspect of the Weaver case is the Court's indication that the scope of the federal securities laws is limited to those frauds involving instruments having "equivalent values to most persons" and the ability to be "traded publically." The phraseology "equivalent values" seems to connote some readily ascertainable value that would facilitate trading in the interest. Accordingly, the Court refused to apply the federal securities laws to this "unique agreement, negotiated one-on-one..."
by the parties." Thus, while the Court purported to reaffirm the applicability of the antifraud provisions of the federal securities laws to "uncommon and irregular instruments," it was willing to leave parties to unusual, negotiated transactions to their remedies, if any, under other laws. This is perhaps the most controversial portion of the Court's opinion. One criticism of this position is that "[t]he Court confused the issue of what constitutes a security and those securities which are exempt from registration."

While it is true that a number of the considerations mentioned by the Court do seem more pertinent to the question of whether an exemption is available than whether a security exists, an argument can be made in favor of the Court's decision:

"If it can be recognized that the danger of fraud is quantitatively and qualitatively reduced where a transaction is both isolated and private, there is persuasive force in the argument that the application of the special fraud procedures, protections and remedies of the securities laws should be cut off short of the thousands of transactions which involve only a handful of knowledgeable or sophisticated buyers."

A stumbling block to a full understanding and evaluation of *Weaver* is the fact that the Court did not adequately address the "why" question. Thus, it is not possible to reach a conclusion as to whether the Court's thinking on the issues involved in the case was simply muddled, or whether the Court was making a conscious policy decision to remove a large number of transactions from coverage by the federal laws on securities fraud.

---

73 *Id.*
74 *455 U.S.* at 556.
75 BLOOMENTHAL, 1982 SECURITIES LAW HANDBOOK xlix. The author opines that "[t]he Court's rationale for its holding, if an answer to a law examination including the identical question, would probably have been graded F by 97% of the securities regulation professors in the United States." *Id.* at xlviii. See also *Bunch*, *supra* note 64, at 1036 ("the court erroneously equated the registration provisions of the federal securities laws with the antifraud provisions of those laws.").
76 *Coffey*, *supra* note 10, at 411. Coffey agrees, however, with Bloomenthal that "as the statutes are presently written, the isolated nature of a transaction and the element of privativeness are generally relevant only to the issue of whether a transaction should be exempt from registration . . . ." *Id* at 408. He states that "if it were decided that transactions which are both isolated and private should be excluded from the definition of 'security,' such a result could be assured only by an amendment of the definition provision." *Id.* at 411.

http://engagedscholarship.csuohio.edu/clevstlrev/vol33/iss3/15
IV. Post Weaver Certificate-of-Deposit Cases

A. Wolf

1. The District Court Decision

In *Wolf v. Banco Nacional de Mexico*, the issue was whether time deposits in a Mexican bank were securities within the meaning of the federal security laws. The plaintiff, Wolf, deposited $20,000 in each of three different accounts with the defendant, Banco Nacional de Mexico. These three accounts paid interest at net annual rates in excess of thirty percent. Plaintiff's dollars, however, were converted into pesos at the time of the deposit. As a result of devaluations when the plaintiff's pesos were reconverted into dollars, the $60,000 principal had been reduced to approximately $35,000.

Wolf brought suit against the bank alleging violations of the federal securities laws including the sale of unregistered securities and the omission of material information in the sale of securities. The district court held that the Mexican certificates of deposit were securities, however, this decision was reversed on appeal to the Ninth Circuit Court of Appeals. Both opinions merit detailed consideration.

The decision of the district court that the deposits were securities was based on considerations of: 1) the definitional sections of the federal securities laws; 2) *Weaver*; 3) the *Howey* test; 4) alternate tests; and 5) a synthesis of the case law. The court rejected a literal approach to the definitional sections of the federal securities acts. The court noted that both the federal securities laws and the Supreme Court had invited inquiry into "context." The court chided both parties for their "arid literalism." The court then distinguished *Weaver* and found that the *Howey* test was not applicable to debt instruments. Finally, the

---

77 549 F. Supp. 841 (N.D. Cal. 1982), appeal dismissed, 721 F.2d 660 (9th Cir. 1983), rev'd, 739 F.2d 1458 (9th Cir. 1984), cert. denied, ___ U.S. ___, 105 S. Ct. 784 (1985).
78 549 F. Supp. at 842.
79 Id.
80 Id. at 841.
82 549 F. Supp. at 843-44. The court chided both parties for their "arid literalism." Id. at 843.
83 549 F. Supp. at 845. The court noted that the decision in *Weaver* had relied in large part on the existence of abundant protections under the federal banking laws. These protections were not available to the purchaser of a certificate of deposit from a Mexican Bank. In addition, the court noted that the plaintiff in *Wolf* was subject to risks not present in *Weaver*, i.e., the greater risk of a currency devaluation. Id.
84 Id. at 846-47. Although *Forman* had stated that the *Howey* test "in shorthand form embodies the essential attributes that run through all of the Court's decisions defining a security," the district court noted that *Weaver* was the first one in which the Supreme
court considered both the "commercial-investment" test and the "risk capital" test and rejected both as inadequate.\textsuperscript{85}

The final and possibly most significant portion of the district court's opinion is an attempt to synthesize prior case law into a "framework for decision that accommodates the universe of instruments and transactions."\textsuperscript{86} The result was a framework for deciding what is not a security:

The most direct and reliable approach to deciding cases . . . involving instruments or transactions that unquestionably exhibit the elements most commonly associated with securities is to include them within the meaning of a "security" unless they fall into certain well defined categories. This approach is consonant with the structure of the definitional provisions of the Acts, according to which virtually any transaction in which one person provides funds to another with the expectation of gain is a security unless "the context otherwise requires."\textsuperscript{87}

The court read prior case law to establish

[t]hat a transaction in which one person ["the investor"] provides funds to another with the expectation of a financial or economic benefit is a security unless:

(a) the benefit derives largely from the managerial efforts of the investor; or

(b) the investor receives something of intrinsic value which he intends to use or consume; or

(c) the provider of funds is in the business of lending funds in such transactions; or

(d) the person to whom the investor provides funds is merely the investor's agent; or

(e) the transaction is virtually risk-free to the investor by reason of government regulation.\textsuperscript{88}

Applying this analytical framework to the facts of Wolf, the district

\textsuperscript{85} Id. at 847-50. The district court rejected the "commercial/investment" test as providing "little or no guidance to transacting parties and lower courts." Id. at 847. It recognized that the "risk capital" test had never been endorsed by the Supreme Court, but did not believe that this precluded it from considering the test. It rejected the risk capital test because it felt a "risk capital analysis could not yield a principled decision in [the] case." Id. at 850. For a brief overview of the different approaches federal courts have taken in determining whether one form of debt instrument, the promissory note, is a security, see Note, Bank Certificates of Deposit: Notes Not in Tune With Securities Regulation, 10 Fordham Urb. L.J. 469, 478-86 (1982).

\textsuperscript{86} 549 F. Supp. at 850.

\textsuperscript{87} Id.

\textsuperscript{88} Id. at 850-52.
court found that only the exclusion based on the risk-free nature of the transaction as a result of government regulation arguably was applicable. The court conceded that Mexican Banks were regulated thoroughly and that no Mexican bank had become insolvent in fifty years. However, the court concluded that governmental regulation of Mexican banks did not eliminate the most significant risk to investors of time deposits in foreign banks, i.e., the risk of devaluation of the local currency.\textsuperscript{99}

The approach adopted by the court is interesting in that a security may exist if the instrument or transaction falls within the literal language of the statute, unless the instrument or transaction definitely can be placed within an accepted exclusion.\textsuperscript{90} The five categories that the court established as exclusions are intended to give meaning to the statutory language “unless the context otherwise requires.”

The first category of exclusion, involving situations in which the benefit derives largely from the managerial efforts of the investor, can be justified by references to the \textit{Howey} test.\textsuperscript{91} That test requires an expectation of profit from the effort of others; the court referred to franchises as commonly falling outside the definition of security on the basis that any benefit is generally in substantial part a function of the investor’s efforts.\textsuperscript{92} The court’s first exclusion is likely to meet with general approval. One commentator has stated:

To me this participation in the management of the investment is the key to the entire concept of the securities acts . . . . If the investor shares in the management of the project and the decisions which determine whether the investment is a success or failure, then he does not need the protection of the securities acts because he is the master of his own destiny, and his position gives him the right to demand all the information necessary to make the appropriate business decisions. But when he does not have such a right and is dependent on the judgment of another, then he needs protection.\textsuperscript{93}

\textsuperscript{99} Id. at 852-53.
\textsuperscript{90} The approach of the court might not appear novel to many attorneys who probably follow a similar approach in advising their clients. See Hannan & Thomas, \textit{supra} note 5, at 249 (“In advising clients on proposed promotions, counsel would be well advised to treat the matter as if there were a rebuttable presumption that the promotion involved a security . . . .”); Cf. Newton, \textit{supra} note 10, at 173 (“If any doubt exists, counsel should either obtain an SEC opinion or comply with the relevant registration requirements.”). \textit{See generally Smith, Preventing Legal Malpractice} 93-96 (West 1981).
\textsuperscript{91} See \textit{supra} text accompanying note 13.
\textsuperscript{92} 549 F. Supp. at 851 n.14.
\textsuperscript{93} Long, \textit{Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations}, 6 \textit{St. Mary’s L.J.} 96, 120 (1974). \textit{See also} Coffey, \textit{supra} note 10, at 396 (“The danger of fraud being practiced on the buyer is considerably reduced when his initial investment is subjected to the risks of an enterprise with which he is familiar at the time of the transaction and over which he exercises management control.”).
One difficulty with the court's formulation of this exclusion is that it does not clearly answer the question of whether this exclusion would be inoperable in certain cases simply because of the manner in which the transaction is structured, for example, through the sale of stock. This is currently one of the points of contention in the argument, discussed below, as to the validity of the sale-of-business doctrine.  

The second category of exclusion, where the investor receives something of intrinsic value intended to be used or consumed, can be justified by reference to the Forman decision. In that case, the Supreme Court held that shares in a housing cooperative were not securities and pointed out that the "investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments." As a general proposition, commentators are not likely to dispute the court’s second exclusion, which can be justified as being based on the purchaser’s right of control over the purchased item. If this is true then, as with the first exclusion, any profits are due to his or her own efforts. Thus, there is no need for the application of the securities laws because the purchaser is the master of his or her own destiny.  

In other cases, one could argue that, as in Forman, the purchaser lacks

A number of cases support the position that if the investor retains ultimate control, then there is no investment contract. See, e.g., Schultz v. Dain Corp., 568 F.2d 612 (8th Cir. 1978) (purchase of apartment complex and contemporaneous entering of a management contract is not a security; purchaser retained ultimate control over apartment complex); Fargo v. Dain Corp., 540 F.2d 912 (8th Cir. 1976); Dubin v. Merrill, Lynch, Pierce, Fenner & Smith, [1982 Transfer Binder] FED. SEC. L. REP (CCH) ¶ 99,144 (S.D.N.Y. 1983)(nondiscretionary options trading account in which investor selected underlying securities is not a security). In addition, a number of cases applying the sale of business doctrine would support this exclusion. The purchaser, according to several of these cases, has not purchased a security because of his or her ability after purchase to manage the corporate assets. See, e.g., Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981). Weaver would also seem to lend support to this exclusion. In Weaver, the Court noted that the Weavers had retained a measure of control over the operation of the slaughterhouse that was "not characteristic of a security." 455 U.S. at 560.

See infra notes 163-68 and accompanying text.

See Fogel v. Sellamerica, Ltd., 445 F. Supp. 1269, 1277 (S.D.N.Y. 1978); Newton, supra note 10, at 181 ("The distinction between an expectation of profit and consumption lies in the purchaser's right of control over the purchased item. Consumption exists where the purchaser has the right or motivation to control and exploit the purchased item."); Tew & Freedman, In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser, 17 U. MIAMI L. REV. 407, 422 (1973)("The key is that if one takes possession and exploits his purchase, then any profits that eventually accrue will be due to his own efforts. He will remain in control of his chances for success.").

One potential objection to the court's second exclusion, as phrased, is that it arguably fails to take into account the possibility of a mixed or dual motive. Cf. Carney & Fraser, supra note 42, at 109-10 ("Often the commodity or property purchase can serve as a dual purpose of investment and consumption.") The court does not indicate how it would treat the mixed motive situation.
DEFINITION OF A SECURITY

a profit motive and simply is not an investor; rather, he or she is a consumer. Since the securities acts were intended to be investor protection and not consumer protection acts, the purchaser simply does not come within the intended scope of the acts.\textsuperscript{97}

The third category of exclusion focuses on situations in which the provider of the funds is in the business of lending funds for such transactions. The court stated: "This accounts for most cases in which the courts have wrestled with some form of the commercial-investment dichotomy."\textsuperscript{98}

This exclusion appears to have been inspired in large part by the concurring opinion of Judge Wright in \textit{Great Western Bank & Trust v. Kotz},\textsuperscript{99} a case which is discussed by the district court in \textit{Wolf}.\textsuperscript{100} In \textit{Kotz}, Judge Wright stated that commercial loans by banks are generally not investments:

In an investment situation, the issuer has superior access to and control of information material to the investment decision. Rather than relying solely on semi-anonymous second hand market information, as do most investors, the commercial bank deals "face-to-face" with the promissor. The bank has a superior bargaining position and can compel wide-ranging disclosures and verification of issues material to its decision on the loan application . . . . Far from purchasing an instrument whose terms were fixed prior to the time of its offering, the bank negotiated the terms of the note in question.\textsuperscript{101}

Thus, this exclusion may be likewise justifiable on the basis of the lack of need for protection. A party in the business of lending funds is apt to have the ability and means to fend for itself.

It is also worth noting that the concurring opinion of Judge Wright was cited in the \textit{Weaver} opinion.\textsuperscript{102} Judge Wright's concurrence discusses "face-to-face" bargaining and lack of fixed terms in the commercial loan situation. It is interesting to recall that "one-on-one" bargaining and "unique" terms were important factors leading the \textit{Weaver} Court to find that the agreement was not a security.\textsuperscript{103} In summary, \textit{Weaver} seems to support the third exclusion in \textit{Wolf}.

\textsuperscript{97} See, e.g., Guernsey v. Rich Plan of the Midwest, 408 F. Supp. 582 (N.D. Ind. 1976)(Food and freezer plans not securities, being neither purchased or sold as investments); Cf. 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.").

\textsuperscript{98} 549 F. Supp. at 851 n.16.

\textsuperscript{99} 532 F.2d 1252 (9th Cir. 1976).

\textsuperscript{100} 549 F. Supp. at 851 n.16.

\textsuperscript{101} 532 F.2d at 1262.

\textsuperscript{102} 455 U.S. at 560 n.10.

\textsuperscript{103} See supra text accompanying notes 71-76.
The fourth category of exclusion covers situations in which the person to whom the investor provides funds is the investor's agent. The court cited general partnership interests, *inter alia*, as falling within this exclusion\(^{104}\) which can be justified by the principal's right of control over the agent:

If the promoter is a mere agent of the investor, the investor's success is not dependent upon the efforts of others. Instead, the fortunes of the investor, by virtue of his right to control his agent—the promoter—are dependent solely upon the investor's personal efforts. On the other hand, if the promoter vis-a-vis the investor is a principal, the investor has no right to control his activities. Accordingly, the investor's fortunes would be dependent upon the efforts of others.\(^{105}\)

Thus, the agency exclusion can ultimately be distilled down to lack of a need for protection as a result of the principal's control over his or her agent. Presumably, the investor in this situation is the master of his or her own destiny.

The fifth and final exclusion, situations in which the transaction is virtually risk-free to the investor as a result of governmental regulation, is clearly inspired in large part by the *Weaver* decision. "The rationale which appears to underlie *Weaver* is that government regulation sufficiently mitigates the risks to which the investor is exposed to obviate the need to apply the securities acts."\(^{106}\) The decision in *Daniel* would seem to lend additional support to the court's final exclusion, although it was not discussed or cited by the court.\(^{107}\)

Significantly, the district court in *Wolf* spoke of governmental regulation and not federal regulation. Both *Weaver* and *Daniel* involved federally regulated areas. The district court discussed the *Forman* decision, apparently as support for a broader governmental regulation exclusion. According to the *Wolf* court, in *Forman*

the Court, in a footnote, rejected the application of the "risk capital" approach to the facts of the case because the purchasers of the apartments "take no risk in any significant sense"; if dissatis-

\(^{104}\) 549 F. Supp. at 852 n.17. See also infra notes 143-46 and accompanying text.

\(^{105}\) Newton, supra note 10, at 177. One question about the court's fourth exclusion is whether the existence of multiple principals will render the agency exclusion inapplicable. Cf. Tew & Freedman, supra note 96, at 415-18 (suggesting that the existence of multiple principals diminishes the control of any one investor over his or her fortunes, and may result in existence of a security). The exclusion of some multipleprincipal situations from the court's agency exclusion would prevent the withdrawal of the protections of the federal securities laws in situations where the investors in fact were not in control of their own destinies.

\(^{106}\) 549 F. Supp. at 852 n.18.

\(^{107}\) See supra text accompanying notes 45-47.
fied, they could recover their initial investment, and state regulation and nearly total state financing made bankruptcy an "unrealistic possibility."\footnote{549 F. Supp. at 853. But see Forman, 421 U.S. at 867-69 (Brennan, J., dissenting)(existence of state regulation is not a ground for excluding application of federal securities laws).}

One can question whether the fifth exclusion as stated by the court is too broad or, rather, too narrow. Should prior Supreme Court decisions be read to exempt from coverage of the federal securities laws only those transactions subject to extensive federal regulation, or is extensive state, local, or even foreign governmental regulation equally potent to override application of the federal securities acts to transactions within their literal scope?\footnote{109 The court of appeals decision in \textit{Wolf}, for example, held that adequate foreign governmental regulation of banks would result in a finding that a certificate of deposit was not a security. \textit{See infra} text accompanying notes 11921. \textit{See also infra} note 110.} Conversely, are only those transactions which are risk-free as a result of governmental regulation excluded, or are transactions which are risk-free as a result of other factors such as insurance also excluded?\footnote{110 \textit{See, e.g., Note, The Definition of Security: Marine Bank v. Weaver, 24 B.C.L. Rev. 1053, 1077 (1983)("the court [in Weaver] demonstrated that if there is federal legislation and/or an insurance scheme sufficiently protective of investments that it eliminates investor risk, the investment in question will not qualify as a security for purposes of the federal security acts."), See supra note 90.} In any event, what is clear is that the fifth exclusion, like the other four, is ultimately grounded in a perceived lack of need for the protections of the federal securities acts.

The approach taken by the district court in \textit{Wolf} is easily understood in light of the continuing confusion as to what constitutes a security. The court adopted the philosophy that anything within the literal statutory definition is assumed to be a security unless proven otherwise. As a planning matter, the approach taken by the court is a very prudent one.\footnote{\textit{See supra} note 90. The approach of defining by a process of exclusion has been used in other contexts in which it is difficult to define a term or phrase affirmatively. For example, the phrase "transacting business in this state" is defined in the Model Business Corporation Act and many state corporation laws by listing a number of activities that will not be considered to be transacting business in the state. \textit{See MODEL BUSINESS CORP. ACT} § 106 (1971). \textit{See also OKLA. STAT. tit. 19, § 1.199 (1981).}} The term "security" is in essence given a negative definition, or more accurately, is defined through a process of exclusion.

The major problem in adopting this approach is how to determine with some degree of certainty what the exclusions to security status are. It is not entirely clear that the exclusions listed in \textit{Wolf} are exhaustive, or that they are not either over- or under-inclusive.\footnote{111 \textit{See, e.g., supra} notes 105, 109-10 and accompanying text.} For example, there is no exclusion for unique, privately negotiated interests not adaptable to pub-
lic trading. Weaver, however, clearly suggests the existence of just such an exclusion.\textsuperscript{114} It would seem that for the Wolf approach to be of value, one must be comfortable that all the appropriate exclusions have been explicitly identified and that no inappropriate ones have been included. Given the state of the case law, one must seriously question whether this is possible.

2. The Court of Appeals Decision

The district court decision in Wolf was overturned by the Ninth Circuit Court of Appeals in a brief but interesting opinion.\textsuperscript{115} The parties had apparently offered the court a number of tests, such as the "economic reality" test, the "risk capital" test, and the "commercial/investment" test. The court, however, viewed the Weaver case as dispositive.\textsuperscript{116}

The court of appeals considered the amendments to the definition of the term "security" in both the Securities Act and the Securities Exchange Act since the Weaver decision. Those amendments added the following words to the definitional sections of both Acts: "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities . . . ."\textsuperscript{117} Those amendments, however, were not dispositive of the question raised in Wolf. "The legislative history demonstrates that Congress recognized the validity of the precise holding of Weaver on its facts, but at the same time, it also recognized that a different outcome might result in another context."\textsuperscript{118}

Ultimately, the court held that the district court had read Weaver too narrowly, particularly when overemphasizing the fact that the bank had been federally regulated. The court of appeals stated: "We think that the Court found it significant that the issuing bank was regulated, and regulated adequately, not that it was the federal government that had regulated it."\textsuperscript{119} The court also pointed out that the federal banking regulations, so important to the decision in Weaver, would not have protected a depositor in an American bank from the risk of devaluation.\textsuperscript{120}

The court of appeals essentially read Weaver as standing for the proposition that if a bank is so well regulated that there is no risk that insolvency will prevent it from repaying holders of its certificates of deposit in

\textsuperscript{114} See supra notes 58-60, 71-76 and accompanying text. See also First National Bank & Trust v. Thoele, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) 1 98,854 (W.D. Okla. 1982)(which seems to support the view that such an exclusion exists).

\textsuperscript{115} Wolf v. Banco Nacional de Mexico, 739 F.2d 1458 (9th Cir. 1984), cert. denied, --- U.S. ----, 105 S. Ct. 784 (1985).

\textsuperscript{116} Id. at 1461.


\textsuperscript{118} 739 F.2d at 1463.

\textsuperscript{119} Id. at 1462.

\textsuperscript{120} Id.
full, then the certificate is not a security under federal securities laws. The court did not read Weaver as requiring that this regulation be federal regulation, as opposed to foreign governmental regulation, or perhaps, even though the court does not address the question, state regulation. Moreover, although the court was of the opinion that the burden of proving the existence of such regulation should fall on the bank, it was conceded in Wolf that the Mexican government's regulation of Mexican banks offered the same degree of protection to certificate holders as federal regulation of domestic banks does in this country. Thus, the court concluded that the Mexican certificates of deposit were not securities.

The court of appeals decision does not make reference to the list of exclusions from security status that the district court attempted to formulate. Still, the decision indicates that, at minimum, the district court's fifth exclusion, where the transaction is virtually risk-free to the investor by reason of governmental regulation, must be read to include regulation by foreign governments.

In addition, while the Ninth Circuit overruled the decision of the district court as to the facts, its approach is basically consistent with that of the lower court. The court of appeals was willing to look closely at the investor's need for protection in determining whether or not the instrument or transaction involved was a security.

B. Brockton

In Brockton Savings Bank v. Peat, Marwick, Mitchell & Co., the plaintiff Brockton sought to recover from the auditors of Penn Square Bank losses sustained as a result of the purchase of a $1,000,000 certificate of deposit from the now-defunct bank. A federal district court granted the auditor's motion to dismiss the plaintiff's security law claims on the ground that the certificate was not a security within the meaning of the federal securities laws. The plaintiff seized upon the footnote in the Weaver opinion allowing that a certificate of deposit does not invariably fall outside the definition of "security" under the federal securities laws and stressing the need for a case-by-case analysis. Using this "toe-

121 Id. at 1463. The decision of the court of appeals is generally consistent with the position taken in an article written prior to the Supreme Court's Weaver decision. See Kronstein, The C.D. Muddle, 9 SEC. REG. L.J. 395, 39798 (1982). Kronstein argued for a distinction between the certificates of issuers generally recognized as banks in the international banking community, and those issued by an institution which called itself a bank, but which was in reality a "highly speculative investment scheme taking advantage of the lax banking regulations in out-of-the-way jurisdictions." Id. at 398.

122 739 F.2d at 1463-64.

123 See supra text accompanying notes 109-10, 113.


125 455 U.S. at 560 n.11.
The Brockton court rejected the plaintiff’s argument that it had not purchased an ordinary certificate of deposit, but instead had made an investment in a common enterprise consisting of Penn Square Bank and its oil and gas borrowers. Even as characterized, the plaintiff’s investment failed what the court referred to as the “Forman” test. The court did not accept the plaintiff’s argument that the Forman test did not apply to debt instruments. The risk capital test the plaintiff was advocating had never been endorsed by the Supreme Court, and in any event, the plaintiff’s certificate of deposit would fail even the risk capital test. The court also rejected plaintiff’s attempt to distinguish Weaver on the basis that the certificate in that case had a face value of only $50,000, while in Brockton the certificate had a face value of $1,000,000, far in excess of the Federal Deposit Insurance Corporation’s insurance ceiling.

The court was similarly unimpressed with Brockton’s attempt to distinguish Weaver as involving a suit against a bank, heavily regulated by federal banking regulations. Brockton, in comparison, was attempting to sue a bank’s auditors who are not subject to federal banking regulations. The court was of the opinion that a certificate must be a security as to everyone or no one, but that it could not be a security as to some persons and not as to others. “The instrument in question must be found to be a security before recovery under the securities laws can be sought for the alleged fraud of accountants, bankers or anyone else involved with the

126 This is the court’s characterization of Brockton’s efforts.
127 577 F. Supp. at 1284. It is clear from the opinion that in referring to the Forman test, the court essentially is discussing the elements of the Howey test. Id. Applying these elements to the facts, the court stated:

[When Brockton purchased the CD, it could not have had any “reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” Rather, the bank could have expected nothing more than the return of its deposit with interest at a contracted rate; such a return was not dependent at all upon the issuer’s profits.

Id.
128 Id. at 1284-85.
129 Id. at 1285. The court stated the Brockton’s risk was as a depositor. Brockton faced only the risk that the bank would become solvent, and not the risk that the principal value of its investment would decline. Citing Weaver, the court mentioned the virtually complete assurance of repayment that bank depositors enjoy. Id.
130 Id. The plaintiff argued that the Supreme Court’s comment in Weaver that the “purchaser of a certificate of deposit is virtually guaranteed payment in full” should be read to exclude certificates of deposit up to the ceiling of federal deposit insurance from coverage under federal securities laws. Id. (quoting Weaver, 455 U.S. at 568). The court held that Brockton misconstrued the Weaver decision and that the payment in full language was a reference to the historical fact that payment in full has generally been received for the uninsured as well as the insured portion of bank deposits in failed banks and not to insurance coverage. Id.
131 Id.
instrument." Finally, the court was not moved by the plaintiff's contention that since Weaver required a case-by-case factual analysis, a motion to dismiss the action was inappropriate.\footnote{133} The Brockton decision is interesting for a number of reasons. First, unlike the district court in Wolf, the Brockton court decided that the Howey test is applicable to debt instruments.\footnote{134} Second, the rationale of Weaver was found to be dispositive; however, the court did not give much consideration to the application of that rationale to the plaintiff's situation. In Weaver the Supreme Court noted: "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."\footnote{135} The Court, however, added that:

It does not follow [that a] certificate of deposit . . . invariably falls outside the definition of a security as defined by the federal statutes. 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.\footnote{136}

The court in Brockton was unwilling to consider the factual differences between Weaver and Brockton: 1) Weaver did not actually involve a bank that had become insolvent, while Brockton did; 2) the certificate in Weaver was substantially within the FDIC ceiling on insured deposits, while the certificate in Brockton far exceeded the ceiling; and 3) large depositors in Penn Square Bank apparently stood to lose a substantial portion of their principal, unlike the situation in prior failures of FDIC insured banks.\footnote{137} This last factor is the most significant. Brockton treats the Supreme Court's statement about prior failure of FDIC-insured banks as dispositive of the need for analysis of the facts in future cases involving certificates of deposit. This approach, however, seems to ignore several considerations. One is the Supreme Court's statement that certificates of deposit may be securities under the right circumstances; therefore, a case-by-case analysis of each factual setting may be necessary. The other is the possibility that the Supreme Court's conclusion as to the safety of the uninsured portion of bank deposits and the adequacy
of federal regulation of banks may be wrong if facts not available at the time of Weaver are taken into consideration.158

The Weaver decision immediately preceded the collapse of Penn Square Bank. In that failure and several failures since then, it appears as if uninsured depositors stand to lose a significant portion of their principal.159 In addition, as a result of the Penn Square failure and the subsequent and not totally unrelated problems of Continental Illinois Bank, the adequacy of federal regulation of banking has been questioned.160

A final interesting aspect of the court’s decision is its rejection of the notion that a security could exist as to one party, e.g., an auditor, and not as to another, e.g., a bank. The court, concluding its discussion of the status of Brockton’s certificate, stated: “Brockton 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.”161 The question of whether an instrument can be a security as to one person and

---

158 It is clear that a lower court should follow Supreme Court interpretation of statutes. One court has stated: “The doctrine of stare decisis, weighty in any context, is especially so in matters of statutory construction . . . . [T]he bar and the public are justified in expecting the courts, except in the most egregious cases, neither to depart from previous interpretations of statutes, nor to give them a grudging application.” Cottrell v. Commissioner of Internal Revenue, 628 F.2d 1127, 1131 (6th Cir. 1980). The problem is that the Weaver opinion is written in such a manner as to be of virtually no value on facts materially different from those before the Court. See infra text accompanying notes 194-95. Thus, by considering factual differences and the need for protection arising from the particular facts of a case, a lower court would be doing exactly what the Court in Weaver instructed.

159 One reason appears to be a change in policy by the Federal Deposit Insurance Corporation which appears to have adopted an approach designed to discourage large depositors from placing their deposits in poorly run banks by no longer attempting to protect uninsured deposits. See Big Depositors at 2 Failed Banks May Lose Some Funds Due to New FDIC Approach, Wall St.J., Mar. 19, 1984, at 3, col. 2 & 3 (S.W. ed); FDIC Action on Bank Failures Continues Step to Make Big Depositors Pay for Errors, Wall St. J., Mar. 21, 1984, at 14, col. 2 & 3 (S.W. ed). See also Wall St. J., April 30, 1984, at 4, cols. 2 & 3 (S.W. ed); Wall St. J., August 22, 1984, at 29, col. 46 (S.W. ed.). Apparently, however, the policy will not effect the 11 largest banks in the United States, which the federal government has decided are too large to allow to fail. See U.S. Won’t Let 11 Biggest Banks in National Fail, Wall St. J., Sept. 20, 1984, at 2, col. 2 & 3 (S.W. ed).


161 577 F. Supp. at 128667 (citing the defendants’ characterization of Brockton’s argument). See also Darrell, Redefining a “Security”: Is The Sale of a Business Through a Stock Transfer Subject to the Federal Securities Laws?, 12 SEC. REG. L.J. 22, 52 (1984)(“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.”).
not as to another is quite fascinating. At first glance, the answer might appear self-evident. A car is a car and not a bicycle, or in other words, property should be judged on its intrinsic qualities and not on extrinsic factors such as the identity or a characteristic of the buyer or seller, or the method of sale.

There is, on the other hand, substantial authority for the contrary proposition.\textsuperscript{142} The general rule holds that an interest in a general partnership is not a security,\textsuperscript{143} however, a number of courts have recently articulated exceptions to this general rule. Perhaps the best known case is \textit{Williamson v. Tucker},\textsuperscript{144} in which the court stated:

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.\textsuperscript{145}

The second exception clearly looks to qualities of the purchaser rather than to the nature of the instrument to answer the question of the status of the interest for the purposes of federal securities laws. The third exception also appears to examine the characteristics of the seller or some other person, to determine the status of the instrument. The \textit{Williamson}

\textsuperscript{142} The district court in \textit{Wolf} seemed to accept the possibility that an instrument could be a security as to one person and not as to another. It is stated, in a footnote: "That an instrument presumptively a security is treated as exempt when issued because of the protection afforded the investor through government regulation in that transaction does not necessarily mean that it should also be exempt in later transactions in which no such protection is afforded." 549 F. Supp. at 852 n.18.

\textsuperscript{143} See Odom v. Slavik, 703 F.2d 212, 215 (6th Cir. 1983)("Normally, a general partnership interest is not considered a 'security.'"); Fund of Funds v. Arthur Andersen & Co., 545 F. Supp. 1314, 1348 (S.D.N.Y. 1982)("General partnerships or joint ventures are unlikely to come within federal securities jurisdiction 


\textsuperscript{145} 645 F.2d 404 (5th Cir.), \textit{cert. denied}, 454 U.S. 897 (1981). The court stated that an investor who claims that his general partnership interest is a security has a difficult burden to overcome, but held that the plaintiffs' claims were not so insubstantial as to warrant dismissal by the trial court for lack of subject matter jurisdiction.

\textsuperscript{146} 645 F.2d at 424.
decision, and others like it, 146 clearly leave open the possibility that an interest sold to an inexperienced or unknowledgeable individual will be labeled a security, while an interest in the same venture sold to a knowledgeable or experienced individual will not.

A similar phenomenon is possible in those circuits in which the "sale-of-business" doctrine has been adopted. This doctrine essentially holds 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. 147 The doctrine appears to be based on the fact that in this situation, the purchaser of stock is not an investor but is rather an entrepreneur; he or she is in reality purchasing the assets of a business with the purpose of managing those assets. 148 Thus, the sale of stock is merely incidental to a sale of assets.

The sale-of-business doctrine also leaves open the possibility that the same interest may be a security as to one person and not as to another. 149 For example, assume that in a single transaction a purchaser acquires all of the stock of a corporation from twenty shareholders, each of whom owns five percent of the outstanding stock. The purchaser intends to assume an active role in the management of the business. Under the doctrine, it is likely that the purchaser will be held not to have purchased a


148 Sutter v. Groen, 687 F.2d 197, 202 (7th Cir. 1982). The meaningfulness of the investor-entrepreneur dichotomy has been questioned. "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 and entrepreneurs." Reufenacht v. O'Halloran, 737 F.2d 320 (3d Cir.), cert. granted sub nom. Gould v. Reufenacht, ___ U.S. ___, 105 S. Ct. 428 (1984).

149 One author states that "courts upholding the sale of business doctrine have introduced a disconcerting asymmetry into securities transactions in that one party may be dealing in a security while the other is not." Karajala, supra note 35, at 429.
DEFINITION OF A SECURITY

security. Instead he or she has, in effect, purchased the assets of the business to manage and thus is unable to bring suit under the anti-fraud provisions of the federal securities laws for any material misrepresentations or omissions in connection with the purchase. The sellers, however, are likely to be treated otherwise; they will be conceptualized as having parted with investments in the corporate entity rather than with pro rata shares of the corporation assets.160

V. JUDICIAL DISAGREEMENT ON OVERRIDING QUESTIONS OF POLICY: A CONTRIBUTING FACTOR IN THE CONFUSION

One source of the current confusion over the scope of the definition of "security" is a disagreement about how much judicial time and effort should be spent identifying those cases believed to be outside the purposes of the securities acts. A sample of the different views on this subject is apparent in the colloquy between the Second and the Seventh Circuits on the sale-of-business doctrine. The Second Circuit held that corporate stock is a security even when the purchaser is an entrepreneur purchasing assets to manage. In Golden v. Garafalo,161 Judge Winter, writing for the majority, stated that "the dangers of creating uncertainty as to the scope of the Acts and in generating slippery legal and factual issues going to jurisdiction are substantial."162 Judge Winter accepted the argument that the Second Circuit's rejection of the sale-of-business doctrine resulted "in a certain overbreadth in application."163 The Judge was not, however, particularly concerned about this; apparently he perceived this overbreadth to be the product of a conscious legislative choice.164

In an opinion by Judge Posner, the Seventh Circuit stated in Sutter v. Groen:165

The problem of drawing lines was the principal reason given by

160 The possibility that the same interest might be a security as to one party and not as to another has not gone unrecognized by the federal courts. See, e.g., Ruefenacht, 737 F.2d at 320. In rejecting the sale-of-business doctrine, the court in Ruefenacht pointed out that under the doctrine:

Instruments purchased by multiple investors might be securities as to some purchasers and nonsecurities as to others, or securities as to sellers but not as to purchasers. Instruments might be securities if traded in a series of small transactions but nonsecurities if the same transaction is effectuated in a single sale.

Id. at 331-32. Even proponents of the doctrine have recognized the apparent strangeness of this phenomenon. See, e.g., Seldin, supra note 147, at 681 n.107 (where the author attempts to argue that the "strangeness of this result is largely superficial").

161 678 F.2d 1139 (2d Cir. 1982).

162 Id. at 1146. Cf. Dillport, supra note 10, at 121 ("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").

163 678 F.2d at 1146.

164 Id. See infra note 173.

165 687 F.2d 197 (7th Cir. 1982).
the Second Circuit in *Golden* for rejecting the sale of business doctrine . . . . We agree that the costs of administering legal rules 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 cost savings we doubt they could justify expanding liability to reach substantive evils far outside the scope of the legislature’s concern.\(^\text{156}\)

The Seventh Circuit, thus indicated a willingness to engage in case-by-case analysis, if necessary, to determine whether application of the federal securities laws would be consistent with the purposes behind those laws i.e., the protection of investors.

To the extent that a literal approach to the definition of a security is rejected, the need for a case-by-case analysis may be unavoidable. If the *Howey* test is viewed as universal, applicable to interests specifically listed in the statutory definitions as well as the catch-all phrases, then the federal judiciary can expect to expend a far greater amount of time and energy on the sifting process.\(^\text{157}\)

---

\(^{156}\) *Id.* at 202. It has been suggested that "the costs of legal rules accrue not only to the courts but to those members of the public who must structure their affairs accordingly." Reufenacht v. O’Halloran, 737 F.2d 320, 332 (3d Cir.), cert. granted sub nom. Gould v. Ruefenacht, ___ U.S. ___, 105 S. Ct. 428 (1984). Perhaps this cost is not adequately reflected in the calculations of the Seventh Circuit in *Sutter v. Groen*. The court in *Ruefenacht* stated that under the sale of business doctrine:

>Counsel must be hired to predict whether the purchase of a large block of stock will render it a security or a nonsecurity. 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. 737 F.2d at 332-33.

On the other hand, the regulations imposed upon an interest found to be a security may raise the costs of its promotion and sale. One author states:

>Those costs may pose entry barriers that some businessmen will be unwilling or unable to bear; and, if fewer persons engage in a particular business activity because of these regulatory costs, we often find undesirable social consequences such as competitive advantages that accrue to larger, more established firms to whom the regulatory costs are not too burdensome.

Mofsky, *supra* note 18, at 396.

\(^{157}\) One author states:

>By making the definition of security as pliable as putty, to be molded to the facts of the particular case at hand, the courts have gone beyond interpreting the statutes they have usurped the congressional function by rewriting the statutes in a haphazard, ad hoc manner. Where once there stood an organized statutory scheme, there is now a maelstrom of confusion. The effect of the courts ignoring the plain language of the statutes is apparent: stocks are securities, but not these stocks; notes are securities, but not these notes, and so on.
The status of general partnership interests under the securities laws involves the same consideration. If the *Williamson v. Tucker* approach is widely adopted, in many cases a close examination of the facts will be required before a determination can be made as to whether a particular interest is a security. Courts will look to, *inter alia*, the partnership agreement, the uniqueness of the manager’s skill, and the sophistication of the complaining partnership. Thus, significant judicial resources would be spent in determining whether a particular situation is within or without the purposes of Congress in passing the federal securities laws.

On the other hand, a recent federal circuit court opinion finding that a general partnership was not a security chose a substantially different approach. Judge Garth of the Third Circuit examined the statutory rights of a partner under Pennsylvania’s Uniform Partnership Act and concluded that “the role of a general partner, *by law*, extends well beyond the permitted role of a passive investor.” If the approach of this court is adopted, the task of determining the security status of the interests of persons who are general partners within the meaning of the Uniform Partnership Act will be simplified. The interests as a matter of law are not securities; therefore, no substantial investment of judicial resources is required.

Both the district court and the court of appeals decisions in *Wolf* demonstrated a willingness to engage in a case-by-case analysis of the propriety of applying the federal securities laws to certificates of deposit. In fact, the Supreme Court in *Weaver* seems to encourage such an approach. The *Brockton* court, by comparison, was loath to embark on a close analysis of the particular facts of the case. *Weaver* was treated as dispositive of the status of a class of certificates of deposit issued by federally regulated banks, thus eliminating any need for a case-by-case analysis.

The question of how much effort should be expended to determine whether particular instruments or transactions are securities is intertwined with the issue of how much weight should be given to the form or structure of a transaction. Should a court give conclusive effect to the manner in which the parties have structured the transaction, or should it expend effort and resources in an attempt to look behind the transaction?

Darrell, *supra* note 141, at 63. The author’s opinion on the desirability of a case-by-case approach is evident. The Supreme Court’s opinion in *Forman* has been read by many as rejecting a literal approach. See, e.g., *Frederiksen v. Poloway*, 637 F.2d 1147, 1150-51 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

*See supra* text accompanying notes 143-46.


*See supra* note 146.

645 U.S. at 560 n.11.
Again, there is no uniformity of opinion on this question.

In the sale of business area, it has been noted that parties to a transaction may choose one form of a transaction, the purchase and sale of stock, over another form, the purchase and sale of assets, "because of the consequences of choosing that form, including the security law consequences."163 In the sale of business context, it has been suggested that to fail to respect the method in which the parties have structured the transaction may disappoint reasonable expectations and raise the cost of transactions to the parties.164 If a purchaser of corporate stock is unable to rely on the anti-fraud provisions of the securities laws for protection from material misrepresentations and omissions, then other potentially costly means of protection must be sought.165 Thus, the argument goes, courts should respect the intention of the parties in structuring the deal as a sale of stock and apply federal securities laws.

Nevertheless, it has also been suggested that the purpose of the securities acts was "to protect the passive investor, who would not ordinarily take the same precautions as one purchasing for the purposes of control and management."166 The entrepreneur, purchasing a corporation to manage, can "normally be expected to investigate and evaluate and not to rely solely upon the representations of the seller without accounting and/or legal advice."167 From this it has been concluded that "investors ought not to believe they will be protected when they structure transactions in order to avail themselves of protections not due them."168 Thus, the argument goes, courts should look behind the structure of the transaction to determine whether the purchaser of stock is a passive investor or an entrepreneur.

The same type of considerations may be involved in general partner-
ship cases where parties may have relied on nonapplication of the federal securities laws. If courts adopt the Goodwin approach that general partnership interests are not securities as a matter of law, then parties would be able to structure a transaction as a general partnership to avoid application of the securities laws.

The sale-of-business cases are potentially distinguishable from the cases involving general partnership interests. First, "stock" is one of the words included in the statutory definitions of "security." Thus, the Howey test is arguably not applicable to corporate stock. Partnership interests are not specifically named in the definitions and must therefore fall within the catch-all phrases of the definitions in order to be a security. It is clear that a partnership interest must meet the Howey test if it is to be a security.

Second, the federal securities laws are remedial statutes and, as such, have historically been liberally construed. Most remedial statutes probably are somewhat overbroad in application as written and/or judicially construed. This is not, however, particularly frightening; the federal securities statutes address those evils intended to be remedied and, in addition, are applicable to a much smaller group of situations where the evils intended to be remedied are probably nonexistent. Given the possibility that significant judicial resources might be required to effectively sort the wheat from the chaff, one can argue that courts should not be particularly concerned about the potential for parties to opt into security law coverage. This is especially true since in some of the situations which the statutes were not originally intended to cover other evils are remedied by the application of the laws, i.e., frauds perpetrated on entrepreneurs.

The partnership cases present a different situation. It may be more objectionable to remove cases within the intent of the federal securities laws from coverage than to include cases without the purpose of the statute. In

---

168 See supra notes 3 and 4.
169 See supra text accompanying notes 31-35.
170 See supra notes 3 and 4.
172 One author has concluded that the definitions of "security" in the federal securities acts were recognized to be overinclusive at the time of their adoption:

The term [security] was defined broadly enough to bring within the coverage of the Acts many instruments and transactions in which the need for most of the specialized regulation of the Acts was less clear and where the public benefits to be derived from regulation under the Acts were remote. Yet, with limited exceptions, the response to the overinclusiveness of the definition was to exempt securities or transactions from the more onerous requirements of the Acts, such as reporting and registration, but to apply the antifraud protection of the Acts to the transactions in which the instrument was bought or sold.

Dillport, supra note 10, at 122.
173 See Golden v. Garafalo, 678 F.2d 1139, 1145 (2d Cir. 1982).
other words, conscious overapplication of the securities laws may be less objectionable than conscious under application.

A number of cases have held limited partnership interests to be securities.\textsuperscript{176} A \textit{de facto} limited partnership could possibly be given the trappings and legal structure of a general partnership.\textsuperscript{176} It would be difficult, however, to harmonize the purpose of the nonwaiver provisions of the federal securities laws\textsuperscript{177} with a judicial approach permitting these \textit{de facto} limited partnerships to be used to avoid the federal securities laws. Thus, the opting out of the coverage of securities laws may be cause for serious concern.

The \textit{Forman} case is a major obstacle in attempting to distinguish sale-of-business cases from those involving general partnership interests. The Supreme Court looked at more than the form of the transaction. In particular, \textit{Forman} requires an examination of the economic realities of a case to determine whether a security exists,\textsuperscript{178} or rather, it has been argued, determine what should be \textit{excluded} from the definition of a security.\textsuperscript{179} Thus, structuring a transaction not intended to be covered by the securities laws in any particular form should not be sufficient to bring it within the definition of a security.

Another source of confusion regarding what instruments or transactions are appropriately included within the term "security" is the question of how far judges should go in considering perceived lack of need for protection as a factor in the decision. Again, this question is difficult to separate from those of how much effort should be expended in sorting out non-securities, and how much weight should be given to the form of a transaction. For example, Judge Lumbard argued in his dissenting opinion in \textit{Golden} that in rejecting the sale-of-business doctrine, the "majority extend[ed] the protections of the securities laws to plaintiffs not in need of those protections . . . ."\textsuperscript{180}

\begin{itemize}
  \item \textsuperscript{176} See, e.g., Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), cert. denied, 440 U.S. 939 (1979)(limited partnership interest involved was a security as a matter of law); Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975), aff'd, 553 F.2d 750 (2d Cir. 1977). See also \textit{Long, supra} note 143, at 583.
  \item \textsuperscript{177} \textit{Cf. L. Loss, FUNDAMENTALS OF SECURITIES REGULATION} 199 (1983)("Indeed, even interests in something called a general partnership may be securities when the venture, though a general partnership \textit{de jure}, functions \textit{de facto} like a limited partnership.").
  \item \textsuperscript{179} 421 U.S. at 848-58.
  \item \textsuperscript{179} See \textit{Thompson, supra} note 31, at 234-35. Of course, an important question here is whether corporate stock is subject to the economic realities test. See \textit{supra} text accompanying notes 31-35.
\end{itemize}
DEFINITION OF A SECURITY

Considering the need for protection is not limited to sale-of-business cases. In fact, it can be suggested that the whole scheme of exclusions developed by the district court in Wolf is grounded on a perceived lack of a need for protection in the case of instruments or transactions that fall within the exclusions. The decision of the court of appeals in Wolf is based on the existence of the protection of Mexican banking laws. Additionally, the district court in Brockton appeared to borrow the Weaver Court's comments regarding the protections of federal banking laws. It would not be bold to suggest that recent Supreme Court decisions have engaged in such an approach and, thus, have encouraged the lower federal courts to do the same; Forman, Daniel, and Weaver can be read as permitting just such an approach. Indeed, one author has suggested that, based on the Weaver decision, one could infer that "the Supreme Court would decide that a one-on-one negotiated sale of a business through a stock transfer is not security" because of the existence of other adequate protections in that situation.

VI. IS THERE ANY HOPE?

At this point, one might fairly ask what can be done to dispel the continuing confusion over what is included within the term "security." The suggestion that a careful review of Supreme Court cases would decide the issue can now be rejected; close examination has shown that these cases have, in part, been the source of the confusion. For example, the Court's decision in Forman must be considered a primary, albeit unintentional, source of the controversy over the sale-of-business doctrine. In addition, the Howey test, which at one point stood for the proposition

---

181 Cf., e.g., Orbe, A Security: The Quest for a Definition, 12 SEC. REG. L.J. 220, 232 (1984). In discussing the status of loan participations under the federal securities laws, the author states that in denying security status "[s]ome courts have adopted the premise that banks do not need the protection of securities acts . . . ." He argues that this conclusion is incorrect.

182 See supra text accompanying notes 77-114.

183 See supra text accompanying notes 115-23.

184 See supra text accompanying notes 124-50.

185 Darrell, supra note 141, at 57. The author states that this protection "is provided by (1) the presence of an attorney at the negotiations; (2) contractual warranties; and (3) state antifraud laws." Id. To the extent that state courts look to federal case law in defining the term security under state law, however, the existence of protection under state securities laws is questionable. See Karajala, supra note 35, at 438-39.

186 It is likely, however, that the parsing of such cases will continue. Cf. Seagrave Corp. v. Vista Resources, 696 F.2d 227, 229 (2d Cir. 1982), cert. granted, ___ U.S. ___, 104 S. Ct. 2341, appeal dismissed, ___ U.S. ___ 105 S. Ct. 25 (1984)("Like modern day beachcombers with 'finders' rods seeking treasure beneath the sand, circuit courts cull through Supreme Court decisions in search of a phrase to fortify their view of how 'security' is defined under the Acts.").

187 See supra notes 31-35 and accompanying text.
that the federal securities laws were flexible enough to comprehend novel and unique schemes, has itself now become a source of confusion.\textsuperscript{168} The test has been described as having been converted into an inflexible standard that operates as an obstacle to securities regulation.\textsuperscript{189} The catch-all phrase "investment contract" may today have become a tool through which the court can narrow generally the scope of the securities acts.\textsuperscript{180}

The Supreme Court's most recent pronouncement on the definition of a security provided precious little clear guidance except: 1) an extensive system of federal regulation and/or federal insurance may prevent an interest from being a security; and 2) certain unique instruments, negotiated one-to-one and incapable of public trading are not securities. At the same time, this decision has been criticized as being confused,\textsuperscript{191} grounded on potentially inaccurate information,\textsuperscript{192} and giving inadequate guidance as to when lack of need for protection, or the uniqueness of an instrument, will justify nonapplication of the federal securities laws.\textsuperscript{193}

One commentator has stated: "The Supreme Court's decision in \textit{Weaver} will probably resolve the security issue as it relates to certificates of deposit, but will be of little assistance otherwise ... .\textsuperscript{194}" Consideration of the \textit{Wolf} and \textit{Brockton} decisions suggests that \textit{Weaver} may not even have laid to rest the general question of the status of a certificate of deposit. In addition, the uncertainty created by this decision may generate additional litigation.\textsuperscript{185}

A number of authors have written extremely thoughtful and scholarly articles proposing redefinitions or attempting to clarify the definition of

\begin{footnotes}
\item[168] One might question whether the problem is that a perfect test for the existence of a security is simply unattainable. Cf. Hannan & Thomas, supra note 5, at 248 ("Howey has the apparent benefit of certainty and definiteness, but the problem is that the real world is not as simple as the \textit{Howey} formula or any other formula. Therefore, the courts have been forced to resort to devices nearly as clever as those of the entrepreneurs in order to fit the schemes within the 'test.'").
\item[169] See Long, \textit{An Attempt to Return 'Investment Contracts' to the Mainstream of Securities Regulation}, 24 \textit{Oklahoma L. Rev.} 135, 177-78 (1971) ("it is time to abandon the rigid formula which the courts have converted the \textit{Howey} definition into, a situation even the \textit{Howey} court would be the first to reject, and realize that 'investment contracts' are a tool to be used in securities regulation rather than an obstacle to such regulation.")
\item[180] See Comment, \textit{Catchall Investment Contracts: The Economic Realities Otherwise Require}, 14 \textit{Cum. L. Rev.} 135, 148 (1984) ("The current trend in the Supreme Court is constractive. 'Investment contract' no longer constitutes a regulatory snare; conversely, the term ironically afforded the Court [in recent cases] the occasion to narrow the scope of the Securities Acts generally."). See also Orbe, supra note 181, at 243-45 (decisions as to definition of "security" have effect of defining the jurisdiction of the federal securities laws).
\item[181] See supra text note 75 and accompanying text.
\item[182] See supra text notes 137-40 and accompanying text.
\item[183] See Note, supra note 110.
\item[185] Bunch, supra note 64, at 1042-43; Note, supra note 20, at 599.
\end{footnotes}
the term "security." These proposals are intended to offer greater predictability of results while remaining faithful to the perceived congressional intent that inspired the federal securities laws. There is no question that greater predictability of result is desirable in this area. It is unlikely, however, that greater certainty can be obtained without action by the Supreme Court. Scholarly reformulations of the definition are of limited value unless the Court is willing to accept and act on the reformulation. The Court expressly declined to adopt the proposed risk capital test in Forman, and the Court may have passed up another opportunity to do so in Weaver. Additionally, while Weaver appears to incorporate elements of a recent scholarly redefinition of "security," the Court's sole reference to the article was in connection with its statement that the Securities Exchange Act "was adopted to restore investors' confidence in the financial markets." The Court failed to specifically approve this reformulation, casting doubt on whether this Article can provide guidance as to what the Court might consider to be a security in the future.

Unfortunately, reasonable minds cannot agree on the definition of a "security;" this is exemplified by the recent split among the circuits.

---

196 See, e.g., Coffey, supra note 10; FitzGibbon, supra note 48; Hannon & Thomas, supra note 5; Long, supra note 189; and Newton, supra note 10. One recent commentary states: "The search [for a definition of a security] appears endless, and as the volume of literature expands, so does the confusion." Orbe, supra note 181, at 221.

197 See Karjala, supra note 35, 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, supra note 10, at 167 ("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 mandates clarity, not confusion."); Cf. Long, supra note 93, at 96 ("It is interesting that in the more than 60 years of securities regulation in this country, we still have no clearly accepted definition of a security.").

As might be expected, the value of a clear and predictable definition of a security has not escaped mention by the courts. See, e.g., Golden v. Garafalo, 678 F.2d 1139, 1146 (2d Cir. 1982); Ruefenacht v. O'Halloran, 734 F.2d 320, 332 (3d Cir), cert. denied sub. nom. Gould v. Ruefenacht, ___ U.S. ___, 105 S. Ct. 428 (1984).

198 But cf. Colson v. Bertsch, 586 F. Supp. 1289, 1296 (D.N.J. 1984)("What is required in this area is not more judicial pronouncement but rather legislative clarification.").

199 421 U.S. at 857 n.24.

200 Bunch, supra note 64, at 1037.

201 The decision seems to incorporate some of the thoughts contained in FitzGibbon, supra note 48. For example, the Court's conclusion that unique instruments not designed to be publicly traded were not securities is generally consistent with FitzGibbon's definition of a security as an instrument which is or is capable of being the subject of transactions in the financial markets. Note, supra note 110, at 1082 n.257.

202 455 U.S. at 555 n.4.

203 See Note, supra note 110, at 2080-84, for an attempt to clarify the Weaver case, in part by reference to Professor FitzGibbon's proposed redefinition of the term security. See FitzGibbon, supra note 48.

regarding the sale-of-business doctrine. Currently, the purchase of the majority of the stock of a corporation, with the intent to take an active role in management, is a security in some, but not all, of the circuits.\textsuperscript{205} The different approaches of the circuits to the commonality requirement and the status of notes indicates that the meaning of the term "security" is not self-evident to a reasonable person.\textsuperscript{206}

A uniform and predictable definition of the term "security" is, in the end, more important than the ultimate direction that the definition takes.\textsuperscript{207} A clear definition will facilitate pretransaction planning and reduce the amount of litigation on the definitional issue. Thus, the most, and perhaps only, effective solution to the problem of clarifying the definition of a security for the purposes of federal securities laws is new and real guidance from the Supreme Court.\textsuperscript{208} Unfortunately, the Court in the past has often refused to review securities law cases involving important, unsettled questions.\textsuperscript{209} Those cases that have been received have been decided as narrowly as possible, without even a small amount of guidance regarding undecided issues.\textsuperscript{210}

(D.N.J. 1984) ("The court recognizes that it here confronts a difficult issue about which reasonable minds can, and have, differed. It awaits guidance from the higher courts or, preferably, from Congress ... ").

\textsuperscript{206} See id., indicating that four circuits had accepted the doctrine and four had rejected it, giving citations.

\textsuperscript{207} See supra notes 19-21 and accompanying text (discussing the different views on the commonality issue); Note, supra note 85 (a brief discussion of the different approaches the federal courts have taken on the status of notes under the federal securities laws).


\textsuperscript{210} Aaron v. S.E.C., 446 U.S. 680, 686 n.5 (1980)(case decided that scienter required in actions by the Securities and Exchange Commission to enforce § 10(b) of the Securities Exchange Act of 1934 and S.E.C. rule 10b-5; left open issue of whether scienter includes reckless behavior); Chiarella v. United States, 445 U.S. 222, 236-37 (1980)(case held that affirmative duty to disclose nonpublic information is necessary for violation of § 10(b) of Securities Exchange Act; left open issue of whether such a duty can arise from misappropriation of information); International Brotherhood Teamsters v. Daniel, 439 U.S. 551, 557 n.9 (1979)(holding that interest in compulsory, noncontributory pension plan was not a security; expressing no opinion on issue of whether an implied cause of action exists under § 17(a) of the Securities Act of 1933); Piper v. ChrisCraft Industries, Inc., 430 U.S. 1, 42 n.28 (1977)(tender offeror does not have standing to sue for damages under the Williams Act; leaves open the question of whether shareholder-offerees or a target company have standing to sue under § 14(e) of the Securities Exchange Act of 1934); T.S.C. Ind. v. Northway, Inc.,
Recently there have been nine petitions for certiorari to the United States Supreme Court in cases involving the definition of a security.\textsuperscript{211} The Court has agreed to hear three of the cases, although one has subsequently been settled. The Court has denied review in six cases.\textsuperscript{212} The number of requests for review probably reflects both the disarray of the legal principles involved and the relative importance of the issue to the business and legal communities.\textsuperscript{213} The Court could, if it so desired, resolve some of the many questions discussed in this article in the two cases it is reviewing and one or two additional carefully selected cases. To do so, however, the Court would have to decide the cases in a manner that gives meaningful guidance; in particular, the Court would have to decide the cases on a basis that has meaning beyond the facts and circumstances of the particular case at hand. In large part, this would involve answering the "why" question and, perhaps, suggesting answers to questions not expressly raised in the cases.

Greater predictability would be possible if attorneys understood the basic philosophy guiding the Supreme Court in this area. The Court's phi-

---

426 U.S. 438, 444-45 n.7 (1976)(case decided what is a material fact under S.E.C. rule 14a9; expressed no opinion on issue of showing of culpability necessary to establish liability under § 14(a) of the Securities Exchange Act of 1934 and S.E.C. rule 14a9); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191-94 nn. 7 & 12 (1976)(scienter is a necessary element in implied cause of action for damages under § 10(b) of Securities Exchange Act of 1934 and S.E.C. rule 10b-5; left open the issues of whether aiding and abetting liability was possible under these provisions, the elements of aiding and abetting liability if it did exist, whether and under what circumstances recklessness would meet the scienter requirement, and whether scienter would be required element in Securities and Exchange Commission enforcement actions brought under these provisions); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 734 n.6 (1975)(one must be a purchaser or seller of a security to have standing to sue for damages under § 10(b) of the Securities Exchange Act of 1934 and S.E.C. rule 10b-5; expressed no opinion on the question of whether a implied cause of action exists under § 17(a) of the Securities Act of 1933). "The greater the number of qualifications, the less the Court is saying. And the more an opinion is limited to a relatively specific factual pattern, the less someone faced with a slightly different factual situation can rely on what the Court has already said." Schauer, supra note 207, at 12.


\textsuperscript{212} See supra note 211.

\textsuperscript{213} See supra note 197.
losophy was apparent for some time after the *Howey* decision; however, it is clear that this is not the case today. It is impossible to discern what policy is currently guiding the Court. The Justices may have decided to reallocate cases between the federal and state court systems. The Court may also have reached the unarticulated conclusion that the benefits of regulation in this area are often outweighed by the costs; possibly the purpose of the securities laws is simply to guarantee the integrity of financial markets. The Court should clearly state why it has decided that an instrument is or is not a security. Until the Court states its underlying philosophy, the ability to predict the future course of this area of the law will be minimal.

The request that the Court lay down rules to provide guidance concerning situations not before the Court might, at first glance, seem objectionable. However, the suggestion that the Court intentionally salt its opinions with *obiter dicta* is supportable in light of the importance of the issue, the need for predictability, and the relatively few opportunities the Court has to provide such guidance. The obligation of the Court to provide

---

24 To a large extent, this was the effect of the Court’s decision in Sant Fe Indus. v. Green, 420 U.S. 462 (1977). In that case the Court held that § 10(b) of the Securities Exchange Act of 1934 and S.E.C. rule 10b-5 did not provide a remedy in cases of mere corporate mismanagement, unaccompanied by deception or manipulation. The Court evidenced a disinclination to bring within the aegis of the above provisions “a wide variety of corporate conduct traditionally left to state regulation.” *Id.* at 478. See also *infra* note 217.

215 See Comment, *supra* note 190 at 163, seeming to indicate that this is the current philosophy guiding the Court in determining whether a security exists. Cf. Mofsky, *supra* note 18, at 396 (“the very philosophy underlying the securities laws is being questioned, and there is a growing body of empirical evidence that securities regulation is more harmful than beneficial to society.”); Lothian, *The Role of the Government in the Securities Market*, 33 U. MIAMI L. REV. 1587 (1979)(government regulation of securities markets do not justify the costs of such regulation); Note *Recklessness Under Section 10(b)*: *Weathering the Hochfelder Storm*, 8 RUT. CAM. L. J. 325, 326-29 (1977)(recent securities law decisions of Supreme Court reflect its probusiness attitude).

The focusing by the Court on the need for the protections of the federal securities laws would suggest that the Court may be attempting to limit the application of the securities laws, on a case-by-case basis, to those situations in which the benefits of regulation are perceived to outweigh the costs. For example, the Court might have entertained the belief that the existence of the federal scheme of banking regulation in *Weaver* made it likely that the benefits of applying the securities laws to certificates of deposit would be outweighed by the costs.

216 See *supra* notes 201-13 and accompanying text.

217 Vague statements such as “we are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud” are inadequate. *Weaver*, 455 U.S. at 556. The important question is which frauds are covered. The Court has given real guidance in a few securities law cases. Santa Fe, 430 U.S. at 462 is a good example. See, e.g., O’Brien v. Continental Illinois Nat’l Bank & Trust Co., 431 F. Supp. 292 (N.D. Ill. 1977), appeal dismissed, 566 F.2d 1175, *rev’d in part*, 593 F.2d 54 (7th Cir. 1979); Altman v. Knight, 431 F. Supp. 309 (S.D.N.Y. 1977). There is no reason to believe that it could not do so again.

218 The question of whether the Supreme Court should venture beyond the task of decid-
clear guidance on a particular issue is inversely related to the number of cases it accepts involving the issue. 219 Due to the Court's position in the federal court system, a lack of guidance is felt at lower levels. 220 Lower courts should, and most likely would, follow "clear, direct, explicit, and unqualified" dictum of the Court; 221 thus, although the command to follow might be absent, an invitation would at least be present. 222

VII. Conclusion

Substantial doubt remains as to a number of important questions regarding the definition of security under the federal securities laws. These include, but are not limited to:

1) whether the Howey test is a universal test, which all securities must meet, or is merely meant to give content to the catch-all provisions of the statutory definitions;
2) whether horizontal commonality is required, or whether vertical commonality is sufficient;
3) whether an instrument can be a security as to one person and not to another;
4) when lack of need for protection will result in a finding that the federal securities laws are not applicable; and
5) what are the basic underlying policies guiding the Court in deciding whether an instrument or a transaction is a security.

The Supreme Court has both the ability and the responsibility to bring clarity to this area; it is to be hoped that the Court will make use of the numerous opportunities it has to dispel the confusion. This is an area

---

219 Schauer, supra note 207, at 23.
220 Id. at 4.
where the Court's performance should, in large part, be judged not by whether its conclusions are correct, but rather by whether its decisions are useful to those in need of guidance. 223

223 Schauer, supra note 207, at 24. Schauer states:
It may be too much to expect that the Court will always reach the "correct" result, but it is not too much to expect that the Court will at least always perform its functions with care. One of those functions is that of guiding others, and it is a function that deserves much closer attention.