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THE SALE OF BUSINESS DOCTRINE: *LANDRETH* ADDS NEW LIFE TO THE ANTI-FRAUD PROVISIONS OF THE SECURITIES ACTS

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INTRODUCTION

In response to the stock market crash of 1929, Congress promulgated the Securities Act of 1933[1] to protect innocent investors from fraudulent securities transactions.[2] The Act requires the registration[3] of most securities with the Securities and Exchange

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1. 15 U.S.C. §§ 77a-77aa (1982). Initially, the Federal Trade Commission administered the 1933 Act. However, the Securities and Exchange Act of 1934 created the Securities and Exchange Commission to administer both Acts. 15 U.S.C. § 78d (1982).

2. *See* 1 L. LOSS, SECURITIES REGULATION at 105-07 (2d ed. 1961); W. CARY, POLITICS AND THE REGULATORY AGENCY (1967); Freedman, *A Civil Libertarian Looks at Securities Regulation*, 35 OHIO ST. L.J. 280 (1974).

3. Section 3 of the Act exempts certain securities from registration with the Securities and Exchange Commission. The securities exempted by § 3 include: (1) any security guaranteed by the United States or by any state; (2) any interest in a bank trust fund maintained exclusively for investment and reinvestment maintained by a bank in its capacity as a trustee, executor, administrator or guardian; (3) industrial development bonds as defined in § 103(c)(2) of the Internal Revenue Code; (4) any note with a maturity of less than nine

Commission prior to their public sale.[4] During the registration process, a corporation must inform prospective buyers of securities of all the material facts relating to the securities they desire to purchase.[5] Disclosure, however, is mandated only when the transaction involves the sale of a "security" as defined in section 2(1)[6] of

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months; (5) any security issued by a religious, educational, fraternal or charitable institution; (6) any certificate issued by a receiver in a Title 11 bankruptcy action; (7) securities issued in connection with a corporate recapitalization; (8) securities issued in connection with a corporate reorganization; and (9) any security which is part of an issue offered and sold to residents of a single state when the issuer is also a resident of and doing business in that state. 15 U.S.C. § 77c (1982).

Section 4 of the Act also exempts certain stock transactions such as: (1) transactions by a person other than an issuer, underwriter or dealer; (2) transactions which are not public offerings of securities; (3) certain secondary transactions by dealers; (4) certain broker transactions involving accredited investors as defined in section 2(15) of the Act. 15 U.S.C. § 77d (1982).

4. Section 5(a) of the 1933 Act provides:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
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> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
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> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

15 U.S.C. § 77e(a) (1982). Schedule A of the Act lists information that must be disclosed in the registration statement. 15 U.S.C. § 77aa (1982). For some examples of the information required by Schedule A, *see infra* note 5.

5. Specifically, the Act requires disclosure of the name of the issuer; the state where the issuer is organized; the issuer's principal place of business; the names and addresses of the issuer's officers and directors; the name and address of the underwriters; the names of all persons who own more than ten percent of the stock of the issuer; the general character of the business of the issuer; a fairly complete statement of the sources of capital of the issuer; all information relating to the number and types of shares that the issuer has outstanding; a list of all the liabilities of the issuer; the use to which the capital raised in the offering is to be put; an estimate of the proceeds to be raised in the distribution; the price of the distribution; the share of the proceeds raised in the distribution that will be paid to underwriters; an estimate of all expenses incurred in connection with the offering; the net proceeds derived from any other securities sold by the issuer in the preceding two years; the issuer's balance sheet; a profit and loss statement; a copy of a legal opinion in connection with the legality of the distribution; and a copy of the issuer's charter and bylaws. *See* 15 U.S.C. § 77aa (1982).

6. Section 2(1) provides:

> When used in this title, unless the context otherwise requires—
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> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (includ-

the Act. Consequently, prior to the United States Supreme Court's decision in *Landreth Timber Co. v. Landreth*,[7] defendants in civil lawsuits arising under the Securities Act commonly raised the affirmative defense that federal securities laws have not been violated because there has not been a sale of a "security" within the meaning of section 2(1) of the Act.[8]

Initially, federal courts broadly interpreted the Act to effecuate its remedial purpose.[9] For example, six years after Congress passed the 1933 Act, the Sixth Circuit Court of Appeals in *Otis & Company v. Security and Exchange Commission*,[10] concluded that the 1933 Act "should be so construed as to achieve the purpose of its enactment . . . [and] [t]he obvious purpose of the Congress in its enactment was [the] protection of the investing public."[11] Consequently, the earlier decisions which broadly defined a security resulted in increasing the number of securities transactions within the Act's coverage. Prior to *Landreth*, some court decisions narrowed the definition of a "security" for the purpose of the 1933 Act.[12] These courts based their restrictive interpretations on the preamble to section 2(1).[13]

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ing 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.

15 U.S.C. § 77b(1) (1982).

7. 105 S. Ct. 2297 (1985).

8. For cases in which this defense was successful, *see infra* note 12. For cases in which this defense was not successful, *see infra* note 17.

9. Early cases favoring a liberal interpretation of the term "security" include Otis & Co. v. Securities and Exchange Commission, 106 F.2d 579 (6th Cir. 1939); Securities & Exchange Commission v. Briggs, 234 F. Supp. 618 (N.D. Ohio 1964); Securities & Exchange Commission v. Payne, 35 F. Supp. 873 (D.C.N.Y. 1940); Securities & Exchange Commission v. Starmont, 31 F. Supp. 264 (E.D. Wash. 1940).

10. 106 F.2d 579 (6th Cir. 1939).

11. *Id.* at 583.

12. Cases narrowing the definition of security under § 2(1) include: Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); Kaye v. Pawnee Const. Co., 680 F.2d 1360 (11th Cir. 1982); Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank, 513 F. Supp. 885 (N.D. Ill. 1981); Reprosystem v. SCM Corp., 522 F. Supp. 1257 (S.D.N.Y. 1981); Seagrave Corp. v. Vista Resources, Inc., 534 F. Supp. 378 (S.D.N.Y. 1982), *remanded*, 696 F.2d 227 (2d. Cir. 1982); Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982); Zilker v. Klein, 510 F. Supp. 1070 (N.D. Ill. 1981).

13. For example, in Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir. 1981) the plaintiff purchased all the stock of a business which provided storage facilities for boats. The Sixth Circuit relied heavily on the preamble to § 2(1) to conclude that a security was not present. The preamble to § 2(1) simply states, "when used in this title, unless the context otherwise

The 1933 Act provides that "any note, stock, treasury stock, bond, debenture . . ." and all other instruments expressly named in section 2(1) will be considered a "security"[14] for the purposes of the Securities Act. However, the preamble to section 2(1) provides that named instruments may not be considered a "security" when "the context [of the transaction] otherwise requires."[15]

Prior to *Landreth*, three United States courts of appeals placed undue emphasis upon the qualifying language in section 2(1) and concluded that the sale of one hundred percent[16] of the stock of a business is not a sale of a "security" within the meaning of the Act.[17] The judicial doctrine limiting the definition of a "security" became known as "the sale of business doctrine."[18]

Prior to *Landreth*, the United States courts of appeals were divided over the validity of the doctrine. The Seventh,[19] Tenth,[20] and Eleventh[21] Circuit Courts of Appeals adopted the sale of business doctrine. The Second,[22] Third,[23] Fourth[24] and Eighth[25] Circuit Courts of Appeals, however, rejected the doctrine. In *Landreth*, the United States Supreme Court also rejected the sale of business doctrine.[26]

This article contends that the United States Supreme Court correctly decided *Landreth Timber Co. v. Landreth*. In *Landreth*,

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requires . . . ." 15 U.S.C. § 78b(1) (1982). For the entire text of § 2(1), *see supra* note 6.

14. *See* § 2(1) *supra* note 6.

15. *Id.*

16. For a discussion of sales of less than one hundred percent of the stock of a business, *see* Gould v. Rueffenacht, 105 S. Ct. 2308 (1985).

17. Some cases which upheld the sale of business doctrine and have concluded that the sale of one hundred percent of the stock of a business is not a security within the meaning of the 1933 Act include: Canfield v. Rapp & Son, Inc., 654 F.2d 459 (7th Cir. 1981); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir. 1981); Chandler v. Kew, 691 F.2d 443 (10th Cir. 1977); Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982); King v. Winkler, 673 F.2d 342 (11th Cir. 1982).

18. In 1977, the Tenth Circuit was the first court of appeals to formally adopt the sale of business doctrine. Chandler v. Kew, 691 F.2d 443 (10th Cir. 1977). However, as early as 1967 the Tenth Circuit indicated in dictum that it was inclined to adopt a doctrine similar to the sale of business doctrine. *See* Chiodo v. General Waterworks Corp., 380 F.2d 860, at 863-64 (10th Cir. 1967).

19. Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982).

20. Chandler v. Kew, 691 F.2d 443 (10th Cir. 1977).

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

22. Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982).

23. Glick v. Campagna, 613 F.2d 31 (3d Cir. 1979).

24. Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (4th Cir. 1979).

25. Cole v. P.P.G. Industries, Inc., 680 F.2d 549 (8th Cir. 1982).

26. 105 S. Ct. at 2297.

the United States Supreme Court, in rejecting the sale of business doctrine, concluded that the sale of one hundred percent of the stock of a business is within the definition of a "security" for the purposes of the Securities Acts. This article will examine consequences of the *Landreth* decision to potential plaintiffs who have purchased one hundred percent of the stock of a business. This article will also conclude that the sale of business doctrine contradicted the legislative policy and history behind the federal securities laws.

I. Investor Protection Under the 1933 and 1934 Acts

As early as the year 1225, governments recognized the need to protect investors from fraudulent securities transactions.[27] In the United States, seven centuries later, state legislatures promulgated the first laws to protect investors.[28] These state laws, known as the "blue sky laws,"[29] withstood constitutional challenges that the laws were an unconstitutional overextension of government's power.[30] However, by the twentieth century, blue sky laws became inadequate as corporations discovered that they could dictate securities laws since often multistate corporations commanded greater financial resources than did the state governments.[31] Ineffective state securities regulations contributed to the stock market crash of October, 1929[32] and to the ensuing financial disaster for the investing

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27. King Edward I of Britain promulgated the world's first securities law in 1285. The law required the licensing of London stockbrokers. Kilik, The Work of the Stock Exchange 12 (2d ed. 1934).

28. By 1933, the date of the first federal securities act, 47 of the 48 states had legislation regulating the securities market. Nevada was the only state that did not regulate securities. *See* 1 L. Loss, *supra* note 2, at 30.

29. The first "blue sky laws" developed from an early Kansas statute designed to combat dishonest securities dealers who sold nonexistent building lots in the "blue sky." 1911 Kan. Sess. Laws 133. *See* Mulvey, *Blue Sky Law*, 36 Can. L.T. 37 (1916). For an excellent discussion of the twentieth century blue sky laws, *see* 1 L. Loss, *supra* note 2, at 23-107.

30. *See* Otis v. Parker, 187 U.S. 606 (1903); Brodnax v. Missouri, 219 U.S. 285 (1911).

31. In 1942, six corporations (General Motors, United States Steel, American Telephone and Telegraph, Great Atlantic and Pacific Tea Co., General Electric, and Pennsylvania Railroad) had greater gross revenues than did the State of New York, which was at that time the largest state. *Hearing to Amend Section 7 and 11 of the Clayton Act, Hearings on H.R. 2357 before Subcom. No. 3 of the House Com. on the Judiciary*, 79th Cong., 1st Sess. (1945) serial 8, p. 10. *See also* Adelman, *The Measurement of Industrial Concentration*, 33 Rev. of Econ. and Stat. 269, 295 (1951). *See also infra* notes 186-97 and accompanying text.

32. In October 1929, stock prices on the New York Stock Exchange seldom reflected the actual worth of the corporations. Book values of stocks were often only a fraction of their market values. Nevertheless, investors continued to drive stock prices up by further investments. State regulations led to low margin requirements and allowed investors to buy stock

public.[33]

In March, 1932, the Senate passed a resolution demanding a Congressional probe into the stock market's collapse.[34] Shortly after the Senate resolution, President Roosevelt asked Congress to create legislation with the "broad purpose of protecting investors."[35] Soon after the President's message, the Senate passed an

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with very small down payments. Consequently, the rise in stock market prices was supported by little hard capital. When stock prices began to decline, investors were forced to sell their shares at any price to remain solvent. This led to panic selling and the ultimate crash of the market. *See* 1 L. Loss, *supra* note 2, at 121; 2 *id.* at 1166, 1226.

33. One commentator has noted:

> The losses which investors suffered in the few years following the crash would almost finance a few weeks or months of a modern war. From 1920 to 1933 some $50 billion of securities were sold in the United States. By 1933 half were worthless . . . .The aggregate value of all stocks listed on the New York Stock Exchange on September 1, 1929 was $89 billion . . . .In 1932 the *aggregate* figure was down to $15 billion—a loss of $74 billion in two and one half years.

1 L. Loss, *supra* note 2, at 120.

34. The Senate Banking and Currency Committee conducted the investigation. S. Res. 84, 72d Cong., 1st Sess. (1932) (continued by S. Res. 239, 72d Cong. 1st Sess. (1933) and S. Res. 371, 72d Cong., 2d Sess. (1933).

35. The President's message stated:

> I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.
>
> In spite of many state statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.
>
> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.
>
> The purpose of the legislation I suggest is to protect the public with the least interference to honest business.
>
> This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.
>
> What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations and other agencies handling or using other people's money are trustees acting for others.

S. Rep. No. 47, 73d Cong., 1st Sess., 6-7 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess., 1-2

additional resolution which required the Senate Banking and Currency Committee to study the possibility of creating federal securities laws.[36] Based upon the Committee's eventual recommendations, Congress passed the Securities Act of 1933[37] and, one year later, the Securities and Exchange Act of 1934.[38]

The 1933 and 1934 Securities Acts protect investors in two ways. First, the Acts require public disclosure[39] of all material information[40] relating to the sale of a "security."[41] The disclosure re-

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(1933).

36. S. Res. 56, 73d Cong., 1st Sess. (1933). *See also* S. Res. 97, 73d Cong., 1st Sess. (1933). S. Res. 97 clarified S. Res. 56.

37. 15 U.S.C. §§ 77a-77aa (1982).

38. 15 U.S.C. §§ 78a-78kk (1982).

39. One commentator has suggested that the Securities Act should more aptly be called "the truth-in-securities act" because "Congress did not take away from the citizen his inalienable right to make a fool of himself . . . .It simply attempted to prevent others from making a fool of him." *See* 1 L. Loss, *supra* note 2, at 128.

40. Courts have held that information is material and therefore must be disclosed if it is more probable than not that a significant number of potential investors would want to know the information prior to purchasing the security. *See* Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971). In *Feit*, the court held that there was a failure to disclose a material fact when the board of directors of an acquiring corporation failed to tell the shareholders of the target corporation that the primary reason for the takeover bid was to gain control of the target's large cash surplus. *Id.* at 575. *See supra* note 5 for a discussion of information that must be disclosed to comply with the Act.

41. Section 7 requires issuers to file with the Securities and Exchange Commission a registration statement which publicly discloses information. Section 7 of the 1933 Act provides that "the registration statement . . . shall contain the information and be accompanied by the documents specified in Schedule A." 15 U.S.C. § 77g (1982). For examples of what the registration statement must disclose to comply with Schedule A, *see supra* note 5. Section 2(4) defines "issuer" as follows:

> The term "issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

quirements seek to minimize the chances of fraud in connection with the public sale of securities.[42] Second, the Acts protect investors by providing civil remedies for investors who have been defrauded in the purchase or sale of a "security."[43]

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15 U.S.C. § 77b(4) (1982).

Until an issuer files a registration statement, § 5(a) forbids sales of new securities. Section 5(a) of the Act provides that:

> Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
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> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
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> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

15 U.S.C. § 77e(a) (1982).

However, § 3 of the Act exempts some securities from the registration requirements of § 5. 15 U.S.C. § 77c (1982). Section 4 of the Act exempts some transactions from the registration requirements of § 5. 15 U.S.C. § 77d (1982). For a discussion of these exemptions, *see supra* note 3.

Among the more important information that a seller must disclose to a prospective buyer of a security to comply with the Act's disclosure requirements are the issuer's financial statements and the identities of its major shareholders.

The financial statement that the issuer must disclose include: (1) A statement of the issuer's capitalization, 15 U.S.C. § 77aa(9) (1982); (2) a balance sheet, 15 U.S.C. § 77aa(25) (1982); and (3) an income statement, 15 U.S.C. § 77aa(26) (1982).

Furthermore, the issuer must disclose "the names and addresses of all persons, if any, owning of record or beneficially, if known, more than 10 per centum of any class of stock of the issuer, or more than 10 per centum in the aggregate of the outstanding stock of the issuer as of a date within twenty days prior to the filing of the registration statement." 15 U.S.C. § 77aa(6) (1982).

42. *See* 1 L. Loss, *supra* note 2, at 130-31. *See also supra* note 39.

43. Investors have brought civil suits pursuant to §§ 11, 12(2), and 17 of the 1933 Act and §§ 10 and 14 of the 1934 Act.

Under § 11 an issuer and the issuer's board of directors are liable for misrepresentations or omissions of fact in the disclosure statement. Section 11 of the Act provides:

> (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
>
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
>
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent

Taken as a whole, the Acts' disclosure requirements and civil

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been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

15 U.S.C. § 77k(a) (1982).

For further discussion of § 11, *see* Note, *Section 11 of the Securities Act: The Unresolved Dilemma of Participating Underwriters*, 40 FORDHAM L. REV. 869 (1972); Green, *Civil Liability to Stockholders Under the Securities Act of 1933 and Remedy by Class Action*, 2 SAN DIEGO L. REV. 34 (1965); Comment, *Civil Remedies Available to Buyers and Sellers Under the 1933 and 1934 Federal Securities Laws*, 38 WASH. L. REV. 627 (1963).

For the definition of "issuer," *see supra* note 41. For the judicial definition of "material," *see supra* note 40. The disclosure statement is required pursuant to § 7 of the Act, 15 U.S.C. § 77g (1982). *See supra* note 41. For the disclosure requirements, *see supra* note 5, 15 U.S.C. § 77aa (1982). A successful plaintiff in a section 11 suit can recover the difference between his purchase price and either (1) the value of the "security" at the time the suit commences or (2) the price at which he sold the "security" prior to filing suit. 15 U.S.C. § 77k(e) (1982). Whereas § 11 allows recovery for misrepresentations in the disclosure statement, § 12(2) allows civil relief for oral misrepresentations or omissions of material fact in connection with the offer or sale of a "security."

Section 12(2) provides:

> Any person who—offers or sells a security (whether or not exempted by the provisions of section [3] of this title . . .) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 771 (1982).

For additional information on § 12(2), see R. JENNINGS & H. MARSH, SECURITIES REGULATION 777-79 (1982); Peterson, *Recent Developments in Civil Liability Under Section 12(2) of the Securities Act of 1933*, 5 HOUS. L. REV. 274 (1967); Folk, *Civil Liabilities under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 199, 201-16 (1969).

Although § 12(2) requires privity for recovery, it is considered a "broad antifraud provision" because an action is sustainable even if the security is exempt from the Act's disclosure requirements. *See* R. JENNINGS & H. MARSH, SECURITIES REGULATION 777 (1982).

For a discussion of securities and transactions that are exempt from the Act, *see supra* note 3. For the Act's disclosure requirements, *see supra* note 5, 15 U.S.C. § 77aa (1982).

Section 17(a)(2) and (3) provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to

liability provisions provide investors with considerable protection

make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a)(2)-(3) (1982).

For additional information on § 17(a), *see* Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L. J. 163 (1979); Hazen, *A Look Behind the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641 (1978).

Although § 17(a) only mandates criminal liability for fraudulent securities practices, a majority of courts have concluded that § 17(a) implies a civil cause of action for investors who have been defrauded in the purchase or sale of a security. *See* Surowitz v. Hilton Hotels Corp., 342 F.2d 596 (7th Cir. 1965), *rev'd on other grounds*, 383 U.S. 363 (1966); Lynn v. Caraway, 252 F. Supp. 858, 863-64 (W.D. La. 1966), *aff'd per curiam*, 379 F.2d 943 (5th Cir. 1967), *cert. denied*, 393 U.S. 951 (1968); Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1093-96 (E.D. Pa. 1972); Daniel v. Int'l Bhd. of Teamsters, 410 F. Supp. 541, 546 (N.D. Ill. 1976).

Courts that have concluded that § 17(a) does not create a civil cause of action include: Dyer v. Eastern Trust and Banking Co., 336 F. Supp. 890, 903-05 (D. Me. 1971); Cowsar v. Regional Recreations, Inc., 65 F.R.D. 394, 398 (M.D. La. 1974); Reid v. Mann, 381 F. Supp. 525 (N.D. Ill. 1974); Welch Foods Inc. v. Goldman Sachs, 398 F. Supp. 1393 (S.D.N.Y. 1974); Architectural League of New York v. Bartos, 404 F. Supp. 304, 313 (S.D.N.Y. 1975).

Whereas the plaintiff must be in privity with the defendant to recover under § 12(2), the following cases have held that privity need not be shown for recovery under § 17: Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949). *But see*, O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 U.C.L.A. L. REV. 921 (1984).

Section 4(a) of the Securities and Exchange Act of 1934 established the Securities and Exchange Commission. 15 U.S.C. § 78d(a) (1982). Pursuant to § 10b of the 1934 Act, 15 U.S.C. § 78k(a)(2), the Commission promulgated Rule 10b-5. Rule 10b-5 provides:

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1985).

As early as 1946 in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) a court held that Rule 10b-5 creates an implied civil cause of action. However, it was not until 1971 that the United States Supreme Court acknowledged a civil cause of action under Rule 10b-5 in a footnote to its opinion in Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

For discussions of civil actions brought under Rule 10b-5 see A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 (1977); A. JACOBS, THE IMPACT OF RULE 10B-5 (1980); 3B H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW (1985); Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553 (1981); Hazen, *Implied Private Remedies Under Federal Statutes: Neither a Death Knell Nor a Moratorium—Civil Rights, Securities Regulation, and*

against fraud. The sale of business doctrine prior to *Landreth*,

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Beyond, 33 VAND. L. REV. 1333 (1980); Steinberg, *Implied Private Rights of Action Under Federal Law*, 55 NOTRE DAME LAW. 33 (1979); Brooks, *Rule 10b-5 in the Balance: An Analysis of the Supreme Court's Policy Perspective*, 32 HASTINGS L.J. 403 (1980); Note, *The Codification of Rule 10b-5 Private Actions in the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1615 (1979); Ruder, *Current Problems in Corporate Disclosure*, 30 BUS. LAW. 1081 (1975); Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance and Plaintiff's Reasonable Conduct Requirement*, 26 S.C.L. REV. 653 (1975); Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167 (1974); Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27 (1973); Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. ILL. L.F. 651 (1972); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of the Legislative Intent*, 57 NW. U. L. REV. 627 (1963).

Rule 10b-5 is popular among investors because it creates a relatively advantageous cause of action. For example, whereas §§ 11 and 12(2) of the 1933 Act only allow a defrauded offeree or buyer of a security to recover damages, Rule 10b-5 also expressly provides relief for defrauded sellers of securities. Additionally, courts have applied Rule 10b-5 to secondary resales of securities. *See* Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Sections 11 and 12(2), on the other hand, provide for civil liability only when there has been fraud in an initial sale of a security. *See supra* discussion of sections 11 and 12.

Finally, § 14(a) of the 1934 Act provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

15 U.S.C. § 78n(a) (1982).

Section 14(a) creates criminal liability for fraudulent practices during the scope of a proxy solicitation. However, in J.I. Case Co. v. Borak, 377 U.S. 426 (1964), the United States Supreme Court held that investors can also recover appropriate civil relief for violations of § 14(a). For additional information on § 14(a), see Loss, *The SEC Proxy Rules in the Courts*, 73 HARV. L. REV. 1041 (1960); Loss, *The SEC Proxy Rules and State Law*, 73 HARV. L. REV. 1249 (1960); Lockwood, *Corporate Acquisitions and Actions Under Sections 10(b) and 14 of the Securities Exchange Act of 1934*, 23 BUS. LAW. 365 (1968).

Section 14(e) of the 1934 Act provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (1982).

For additional information on § 14(e) see R. JENNINGS & H. MARSH, SECURITIES REGULATION 857-58 (5th ed. 1981); Jorden and Woodward, *An Appraisal of Disclosure Requirements in Contests for Control under the Williams Act*, 46 GEO. WASH. L. REV. 817 (1978);

however, threatened to negate these two sources of investor protection. Under the sale of business doctrine, investors who purchased one hundred percent of the stock of a business are denied access to disclosure information[44] and the civil remedies under the Acts.

II. The Sale of Business Doctrine

The sale of business doctrine was purely a judicial concept concerning the Securities Acts.[45] Courts that followed the doctrine concluded that neither the disclosure requirements[46] nor the civil causes of action[47] under the 1933 and 1934 Acts apply to securities transactions in which a buyer purchased one hundred percent of a corporation's stock.[48] Prior to *Landreth*, four circuits rejected the doctrine[49] and three circuits accepted the doctrine.[50]

Courts which sustained the doctrine relied upon the United States Supreme Court's decision in *United Housing Foundation v.*

Dugan and Fairfield, *Chris-Craft Corp. v. Piper Aircraft Corp.: Liability in the Context of a Tender Offer*, 35 Ohio St. L.J. 412 (1974).

Section 14(e) outlaws misrepresentations of material fact "in connection with any tender offer" directed towards stockholders. However, civil relief under § 14(e) is not as widespread as civil relief pursuant to § 14(a). *See* Piper v. Chris-Craft Industries, 430 U.S. 1 (1977) (wherein the Supreme Court indicated that even though shareholders of a target company in a take-over bid could recover from the board of directors of the acquiring company, the acquiring company's shareholders could not recover from the target company's shareholders under § 14(e)).

44. Arguably, the purchaser of one hundred percent of the stock of a business does not need the protection that the Securities Acts provide since a purchaser of all a corporation's stock is also purchasing all the corporation's books, contracts and records. However, the 1933 Act's disclosure requirements still benefit large investors because they provide a complete, organized and precise format for disclosing information.

45. Nothing in the text of the Securities Act of 1933 or 1934 mentions the consequences of the sale of one hundred percent of the stock of a business. Courts have had to determine whether or not a specific transaction involving all the stock of a corporation was a sale of a "security" as defined in § 2(1). 15 U.S.C. § 77b(1) (1982). Federal courts have the task of defining the term "security." As early as 1946 the Supreme Court began interpreting the term "security" for the purposes of § 2(1) of the 1933 Act. *See* Securities & Exchange Commission v. W.J. Howey Co., 328 U.S. 293 (1946).

46. For a discussion of disclosure requirements, *see supra* notes 39-41 and accompanying text.

47. For a discussion of civil causes of action under the Acts, *see supra* notes 42-46 and accompanying text.

48. For a list of cases upholding the doctrine, *see supra* note 12.

49. Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982); Glick v. Campagna, 613 F.2d 31 (3d Cir. 1980); Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (4th Cir. 1979); Cole v. PPG Industries Inc., 680 F.2d 549 (8th Cir. 1982).

50. King v. Winkler, 673 F.2d 342 (11th Cir. 1982); Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982); Chandler v. Kew, Inc., 691 F.2d 443 (10th Cir. 1977).

Forman.[51] In *Forman*, the Supreme Court concluded that the "stock" in a non-profit housing cooperative was not a "security" as defined in the Securities Acts.[52] According to the Court, the district court had properly dismissed the stockholders' fraud claims brought pursuant to section 17(a)[53] and Rule 10b-5[54] of the Securities Acts.[55]

In *Forman*, the Supreme Court reiterated a test it had established in *Securities & Exchange Commission v. W.J. Howey Co.*[56] to "embod[y] the essential attributes that run through all of the Court's decision defining a security."[57] Under the *Howey* test, four elements must exist for the sale of a stock to be considered the sale of a "security" under the Securities Acts.[58] First, an investor must make an investment of money.[59] Second, the investment which the investor makes must be pooled with other investments into a common enterprise.[60] Third, the investor must have premised his investment upon a reasonable expectation of profit.[61] Fourth, the profits that the investor expects must be derived from the managerial efforts of other people.[62]

In addition to this four-part test, the Court also stated that the "economic realities" of the transaction will be a consideration in determining which stocks constitute "securities" within the meaning of the Securities Acts.[63] The Court quoted the following language from a prior case: "[i]n searching for the meaning and scope of the word 'security' in the [Securities Acts], form should be disregarded for substance and the emphasis should be on economic reality."[64] The Supreme Court concluded that the four-part *Howey*

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51. 421 U.S. 837 (1975).

52. *Id.* at 848.

53. For a discussion of civil liability under § 17(a) and the text of § 17(a), *see supra* note 43.

54. For a discussion of civil liability under Rule 10b-5 and the text of Rule 10b-5, *see supra* note 43.

55. 421 U.S. at 860.

56. 328 U.S. 293 (1946).

57. 421 U.S. at 852. This test became known as the *Howey* test. 328 U.S. at 301.

58. 421 U.S. at 852 (citing 328 U.S. at 301).

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at 849. The Court noted that "[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." *Id.*

64. *Id.* at 848 (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)).

test and the economic realities of the securities transaction should be considered when "federal courts . . . decide which of the myriad financial transactions in our society come within the coverage of the Securities Acts."[65]

A. The Debate

In *Canfield v. Rapp & Son, Inc.*,[66] the Seventh Circuit Court of Appeals applied the *United Housing* decision to a case involving the sale of one hundred percent of the stock of a company which manufactures machine parts.[67] In *Canfield*, the purchaser of the company's stock alleged that the seller's misrepresentation concerning the value of the corporate assets caused the purchaser to pay an inflated price for the stock.[68] Consequently, the purchaser sued the seller of the stock pursuant to the civil liability provision contained in section 17(a)[69] of the 1933 Act.[70] The Seventh Circuit, however, concluded that the sale of one hundred percent of the stock of a business was not a sale of a security for the purposes of section 2(1) of the 1933 Act.[71] Upon finding that the plaintiff did not purchase a "security" as defined in the 1933 Act,[72] the Seventh Circuit affirmed the trial court's dismissal of the plaintiff's complaint.[73]

The Seventh Circuit cited *United Housing*[74] to support its conclusion that the sale of one hundred percent of the stock of a business did not satisfy the second part of the *Howey* test[75] which requires a pooled investment in a common enterprise.[76] The court held that the transaction failed to satisfy the second element of the

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65. *Id.* at 848.

66. 654 F.2d 459 (7th Cir. 1981).

67. *Id.* at 461.

68. *Id.* at 462. Specifically, the buyer alleged that the seller represented that certain equipment that the corporation currently leased could be purchased for $100,000. The equipment eventually cost the buyer $554,000 in addition to the $2,000,000 that the buyer paid for the corporation's stock. *Id.*

69. For the text of § 17(a) and a discussion of civil liability pursuant to § 17(a), *see supra* note 43.

70. 654 F.2d at 462.

71. *Id.* at 465-66.

72. *Id.* at 468.

73. *Id.* at 460.

74. *Id.* at 463. For a discussion of *United Housing*, *see supra* notes 51-65 and accompanying text.

75. For a discussion of the second element, *see supra* note 60 and accompanying text.

76. 654 F.2d at 464.

Howey test because the purchaser became the sole owner of the machine manufacturer.[77] The court also held that the purchaser failed to establish the fourth element of the *Howey* test,[78] which requires that the investor's expected profits be derived from the managerial efforts of others,[79] because the plaintiff, as the business's new owner, did not expect to derive his profits from the managerial efforts of other people.[80] Instead, the court concluded that, as the new owner of the business, the purchaser expected to derive profits from his own managerial efforts.[81] Consequently, without any independent discussion of the Supreme Court's "economic realities"[82] criteria to be used in defining a "security," the *Canfield* court summarily concluded that, based upon the *Howey* test, "the 'economic realities' of the transaction indicate not a security transaction, but rather the sale of a business, merely using stock as a method of vesting [the purchaser] with total ownership."[83]

Significantly, the Seventh Circuit concluded that the Supreme Court's four-part test in *Howey* was the exclusive and dispositive test in determining what constitutes a "security."[84] In doing so, the Seventh Circuit determined that the Supreme Court's discussion of "economic reality" in *United Housing*[85] was dictum and merely a convenient label by which to refute the notion that a transaction involves a "security" simply because the parties attached the name "stock" to their transaction.[86] In other words, the court deemphasized "economic realities" and concluded that the four-part test was the exclusive method by which to define the term "security."[87]

In *Golden v. Garafalo*,[88] the Second Circuit Court of Appeals also considered what it termed "the recurrent and troubling ques-

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77. *Id.*

78. For a discussion of the fourth element, *see supra* note 62.

79. 654 F.2d at 464.

80. *Id.*

81. *Id.*

82. For a discussion of economic realities, *see supra* notes 63-65 and accompanying text.

83. 654 F.2d at 464.

84. *Id.* at 464-65.

85. For a discussion of economic realities, *see supra* notes 63-65 and accompanying text.

86. 654 F.2d at 464-65.

87. *Id.*

88. 678 F.2d 1139 (2d Cir. 1982).

tions" relating to the sale of business doctrine.[89] In *Golden*, the plaintiff purchased one hundred percent of the stock of a ticket brokerage business.[90] The plaintiff subsequently alleged fraud[91] in the stock purchase and brought suit against the seller pursuant to section 17 and Rule 10b-5.[92] The district court applied the sale of business doctrine and dismissed the plaintiff's section 17(a) and Rule 10b-5 claims.[93] On appeal, however, the Second Circuit expressly rejected the sale of business doctrine and reversed the district court's dismissal.[94]

The *Golden* court echoed the decision of the Seventh Circuit in *Canfield*,[95] and concluded that the sale of one hundred percent of the stock of a business does not satisfy the second and fourth elements of the *Howey* test.[96] However, unlike the Seventh Circuit, the Second Circuit considered the "economic realities" of the transaction as an additional separate and independent test to define the term "security."[97] Consequently, the Second Circuit employs a two-step approach in defining a "security"—the four-part *Howey* test and the "economic realities" test. According to the Second Circuit, a stock that fails to satisfy the four-part *Howey* test may nevertheless qualify as a "security" if the economic realities of a transaction indicate the existence of stock as defined in the Securities Acts.[98]

The Second Circuit reasoned that the characteristics of stock in a particular transaction would determine whether the economic realities suggest the presence of a "security."[99] For example, the economic realities of a transaction would indicate the existence of a "security" if the stock in question is negotiable, represents a

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89. *Id.* at 1140.

90. *Id.*

91. Specifically, the buyer alleged that the seller's fraudulent representations resulted in the buyer paying over $100,000 more than the net asset value of the business. *Id.* at 1146.

92. *Id.* at 1140. For the test of § 17(a) and Rule 10b-5 as well as a discussion of civil liability under those two provisions, *see* § 17(a) and Rule 10b-5, *supra* note 43.

93. 678 F.2d at 1140.

94. The court noted that if the sale of business doctrine was a valid doctrine, then it would have affirmed the trial court's dismissal. *Id.* at 1142. However, the court stated: "We hold that conventional stock in business corporations is a security within the meaning of the '33 and '34 Acts whether or not the underlying transaction involves the sale of a business to one who intends to manage it." *Id.* at 1140.

95. 654 F.2d 459 (7th Cir. 1981). *See also supra* notes 74-83 and accompanying text.

96. For a discussion of the *Howey* test *see supra* notes 59-62 and accompanying text.

97. 678 F.2d at 1143-44.

98. *Id.*

99. *Id.* at 1143.

right of voting control in a corporation, and has a right to appreciate and receive dividends in proportion to the number of shares owned.[100]

In applying the economic realities test to the facts in *Golden*, the Second Circuit concluded that the transaction involved the sale of a "security."[101] Moreover, the Second Circuit expressly rejected[102] the sale of business doctrine because the nature of the doctrine contradicted both Congressional[103] and previous Supreme Court's interpretations of the definition of a "security" for the purposes of the Securities Acts.[104]

In rejecting the sale of business doctrine, the court considered the prefatory language[105] in section 2(1) which provides that "unless the context otherwise requires," the instruments listed in section 2(1) shall be considered a "security."[106] The Second Circuit concluded that the context would require taking a stock sale outside the Act's coverage only when "there is [not a] passive investor entrusting his capital to another. . . ."[107] Therefore, under the Second Circuit's definition of a "security," the sale of all the stock of a business is within the section 2(1) definition of a "security" as long as the purchaser is not a passive investor.

The Second Circuit concluded its consideration of the sale of business doctrine by stating that the doctrine not only "lack[s]. . .clarity" but also is "inherent[ly] elusive as a legal concept."[108] The court concluded that the doctrine would allow "the application of the anti-fraud provisions of the securities laws to turn upon the percentage of shares involved in a transaction [and] would lead to capricious results."[109] For example, under the doctrine, the largest investors who have made the greatest monetary investment would have no protection under the federal securities laws whereas smaller investors would be entitled to full federal securities laws protection.

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100. *Id.* at 1144.
101. *Id.*
102. *Id.*
103. The Court stated: "If the Congress is dissatisfied with the [*Golden* decision] we trust it will act accordingly." *Id.* at 1147.
104. *Id.* at 1144.
105. *See* discussion *supra* notes 13-17 and accompanying text.
106. 678 F.2d at 1141.
107. *Id.*
108. *Id.* at 1145.
109. *Id.* at 1142.

In *Landreth Timber Co. v. Landreth*,[110] the United States Supreme Court laid to rest any notion that the sale of business doctrine has any validity.[111] In *Landreth*, a father and his sons owned one hundred percent of the stock of a family-owned lumber business.[112] The father and sons desired to sell all their stock in the lumber business to the petitioner.[113] Prior to the stock sale, a fire broke out and damaged the company's sawmill.[114] However, the petitioner nevertheless purchased the mill upon the seller's representations that the sawmill would be rebuilt and modernized.[115] After the petitioner purchased all the stock in the rebuilt sawmill, the business was not as profitable as the petitioner expected, and the petitioner resold the mill at a loss.[116] The petitioner then filed suit in federal court for recovery pursuant to the civil causes of action under the federal securities laws.[117]

In *Landreth*, the district court granted the respondents' motion for summary judgment on the grounds that, under the sale of business doctrine, the petitioner did not have standing to sue since the sale of one hundred percent of the stock of a business was not a "security" within the meaning of the federal securities laws.[118] On appeal, the United States Court of Appeals for the Ninth Circuit applied the sale of business doctrine and affirmed the district court's dismissal based upon the Ninth Circuit's interpretation of the Supreme Court's decision in *Forman*.[119] The United States Supreme Court, however, reversed.[120]

In *Landreth*, the Supreme Court, noting that "the starting point in every case involving construction of a statute is the language itself,"[121] elected to reprint the entire text of section 2(1)

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110. 105 S. Ct. 2297 (1985).

111. In *Landreth*, the Court noted that "we think it would improperly narrow Congress' broad definition of 'security' to hold that the traditional stock at issue here falls outside the Acts' coverage." *Id.* at 2303.

112. *Id.* at 2300.

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at 2301.

117. *Id.*

118. *Id.*

119. *Id.* For a discussion of *Forman*, 421 U.S. at 837, *see supra* notes 51-65 and accompanying text.

120. *Landreth*, 105 S. Ct. at 2301.

121. *Id.*

within the body of the *Landreth* decision.[122] After reprinting the text of section 2(1), the Court noted that "the face of the definition shows that 'stock' is considered to be a 'security' within the meaning of the Acts"[123] and that "most instruments bearing such a traditional title *are likely* to be covered by the definition."[124] However, the Court continued by stating that "the fact that instruments bear the label 'stock' is not of itself sufficient to invoke the coverage of the Acts."[125] "Rather," the court concluded that it "must also determine whether those instruments possess 'some of the significant characteristics typically associated with' stock."[126] The Court then identified five characteristics usually associated with common stock: (1) the right to receive dividends contingent upon an apportionment of profits; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the conferring of voting rights in proportion to the number of shares owned; and (5) the capacity to appreciate in value.[127]

In applying these principles, the Court concluded that the stock involved in the sale of the lumber company possessed all five of the characteristics traditionally associated with common stock.[128] Therefore, the Court concluded, it was much more likely that the purchaser of the stock in *Landreth* would be an investor who had believed that he was covered by the federal securities laws.[129] Therefore, the Court concluded that "[u]nder the circumstances of this case, the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts."[130]

In concluding that the sale of one hundred percent of the stock of a business was a sale of a security within the meaning of section 2(1), the Court "recognize[d] that Congress did not intend to provide a comprehensive federal remedy for all fraud"[131] when it promulgated the Securities Act of 1933.[132] However, the Court con-

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122. *Id.* at 2302.
123. *Id.*
124. *Id.* (emphasis added).
125. *Id.*
126. *Id.*
127. *Id.*
128. *Id.* at 2302-03.
129. *Id.* at 2303.
130. *Id.*
131. *Id.*
132. 15 U.S.C. §§ 77a-77aa (1982).

cluded that "it would improperly narrow Congress' broad definition of 'security' to hold that the traditional stock at issue here falls outside the Acts' coverage."[133]

In deciding *Landreth*, the Court rejected the respondents' argument that the economic realities of the transaction required the Court to conclude that the Securities Acts did not apply since the petitioner did not anticipate earning profits from the efforts of others after he became the owner of one hundred percent of the stock of the timber company.[134] The Court rejected the respondents' "economic realities" argument by stating that all of the cases in which the Supreme Court applied the economic realities test involved the sale of "unusual instruments not easily characterized as securities"[135] whereas, the stock sold in *Landreth* involved "traditional stock, plainly within the statutory definition."[136] Moreover, the Court noted that the economic realities test should not be applied in situations where the instruments in question "[fit] within *any* of the examples listed in the statutory definition of 'security.' "[137] Finally, the Court rejected the respondents' argument that the Securities "Acts were intended to cover only 'passive investors' and not privately negotiated transactions involving the transfer of control to 'entrepreneurs.' "[138]

B. Consequences of the Landreth Decision

The *Landreth* decision will result in protection for the investing public in four ways. First, the decision will require a person who sells one hundred percent of the stock of a corporation to comply with the disclosure requirements[139] contained in the 1933 Act. Since the common law does not impose upon a stock seller an affirmative duty to disclose,[140] and since there are inherent costs

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133. 105 S. Ct. at 2303.

134. *Id.* at 2303-04.

135. *Id.* at 2304.

136. *Id.*

137. *Id.* at 2305.

138. *Id.*

139. For examples of information that must be disclosed under the Act, *see* discussion *supra* note 5.

140. *See* Strong v. Repide, 213 U.S. 419 (1909); Keates v. Earl of Cadogan, 10 C.B. 591, 138 Eng. Rep. 234 (1951); Crowell v. Jackson, 53 N.J.L. 656, 23 A. 426 (1891); Boileau v. Records & Breen, 165 Iowa 134, 144 N.W. 336 (1913); Iron City National Bank v. Anderson, 194 Pa. 205, 44 A. 1066 (1899); Windram Mfg. Co. v. Boston Blacking Co., 239 Mass. 123, 131 N.E. 454 (1921).

associated with obtaining information,[141] the *Landreth* decision will ensure that purchasers of one hundred percent of the stock of a business will make a greater number of informed investment decisions. Therefore, the *Landreth* decision conforms to the policy behind the Securities Acts because it strengthens the disclosure requirements in the federal securities laws and decreases the probability that an investor will be the victim of fraud.[142]

Second, the *Landreth* decision ensures that investors receive the civil relief available under the 1933 and 1934 Acts.[143] The decision ensures that statutory remedies are available for purchasers of one hundred percent of the stock of a business since the sale of one hundred percent of the stock of a business is squarely within the coverage of the Securities Acts. Consequently, the decision not only upholds the enforcement provisions of federal securities laws, but it also allows a defrauded investor to utilize federal remedies in addition to the inadequate remedies available under state law.[144]

Third, the decision ensures a defrauded investor a federal fo-

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141. For a discussion of the costs for an investor to obtain disclosure information, *see* Darrell, *Redefining a "Security": Is the Sale of Business Through a Stock Transfer Subject to the Federal Securities Laws?* 12 SEC. REG. L.J. 22, 61 (1984). *See also* Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1440 (1964).

142. It should be noted, however, that many situations which involve the sale of all the stock of a business to one or a few investors might be exempt from the disclosure requirements of the 1933 Act. *See* the discussion of § 4 of the Act, *supra* note 3, 15 U.S.C. § 77d (1982). The definition of a security in the 1934 Act is nearly identical to the definition in the 1933 Act. Section 3(a)(10) of the 1934 Act defines "security" as follows:

> (a) 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, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1982).

143. For the texts and a discussion of all the civil liability provisions, *see supra* note 43.

144. *See infra* notes 185-194 and accompanying text for a discussion of why state laws provide stock investors with insufficient protection against fraud.

rum in which to pursue civil relief. Federal courts are courts of limited jurisdiction;[145] they have subject matter jurisdiction only in cases involving diversity of citizenship[146] or a federal question.[147] A federal question exists when "an important question of federal law is an essential element of the case."[148]

Civil suits pursuant to federal securities laws necessarily raise "an important question of federal law" and lead to federal jurisdiction since the plaintiff is seeking relief pursuant to rights which the federal securities laws have created. Therefore, the sale of business doctrine not only stripped investors of federal civil remedies, but also the doctrine had the incidental effect of stripping investors of a federal forum in which to pursue their rights.[149]

The absence of a federal forum for a securities fraud suit harms investors. Empirical evidence shows that local juries often prejudice nonlocal litigants[150] and particularly nonlocal securities litigants. For example, in a securities suit, a nonlocal investor may seek recovery from a local corporation that is an important source of jobs in the community. In such cases, an investor may be unable to recover his damages upon being defrauded in a securities transaction because of local prejudices.

Federal courts, however, avoid most of the effects of local prejudices for several reasons. First, federal court jurors are drawn

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145. U.S. CONST. art. III.

146. 28 U.S.C. § 1332 (1982).

147. A federal question exists in "all civil actions arising under the Constitution, laws, or treaties of the United States." 28 U.S.C. § 1331 (1982).

148. C. WRIGHT, LAW OF FEDERAL COURTS, 96 (4th ed. 1979). *See also*, Smith v. Kansas City Title and Trust Co., 255 U.S. 180 (1921); Rosenthal & Rosenthal, Inc. v. Aetna Casualty & Sur. Co., 259 F. Supp. 624 (S.D.N.Y. 1966).

149. A plaintiff may always qualify for federal subject matter jurisdiction under diversity of citizenship, 28 U.S.C. § 1332 (1982), even if he is stripped of his federal claims under the sale of business doctrine. However, it is unlikely that a plaintiff will qualify under 15 U.S.C. § 1332 (which requires complete diversity) since typically multiple defendants are named in securities suits, at least one of which is likely to reside in the same jurisdiction as the plaintiff. If *any* plaintiff and *any* defendant are residents of the same state, then there is no federal subject matter jurisdiction based upon diversity of citizenship. *See* Strawbridge v. Curtiss, 7 U.S. 267 (1806).

150. One survey concluded that 60.3 % of attorneys believe that they are more likely to be successful for an out-of-state plaintiff when they try their case in federal court rather than state court. Note, *The Choice Between State and Federal Court in Diversity Cases in Virginia*, 51 VA. L. REV. 178-79 (1965). *See also* Frank, *The Case for Diversity Jurisdiction*, 16 HARV. J. ON LEGIS. 403 (1969); Frank, *For Maintaining Diversity Jurisdiction*, 73 YALE L. J. 7 (1963), *but see* Summers, *Analysis of Factors that Influence Choice of Forum in Diversity Cases*, 47 IOWA L. REV. 933 (1962).

from a wider geographical area than are state court jurors.[151] This decreases the chances that local public opinion will influence a jury's verdict. Second, appellate courts with a multistate perspective review federal trial courts' decisions. Third, federal judges can transfer the case to a federal court in another state when the interests of avoiding local prejudices so requires.[152] Indeed, even the United States Supreme Court has recognized that because of these advantages, federal "judges [are] less exposed to local pressures than their state court counterparts."[153]

Moreover, securities litigation tends to be complex and involve multiple parties.[154] Consequently, juries tend to have difficulty grasping the issues in order to reach a just verdict. In federal courts, judges have broader discretion than do state court judges to comment on the evidence in order to simplify the issues for jurors.[155] The power of federal judges to comment on the evidence presented at trial is not based upon a provision in the Federal Rules of Evidence. Rather, this power has been inherited from the British common law tradition.[156] In recent years, most states have departed from the common law tradition and no longer give their judges the power to comment on the evidence before the jury.[157] However, as Charles Wright notes, federal judges may "summarize, discuss, and comment on the facts and the evidence, provided [they indicate] to the jury that they are not bound by his discussion of the evidence."[158] Wright claims that federal judges' comments on the evidence tends to "clear away false issues" and "lead the jury to a proper understanding of the facts."[159] As a result of

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151. *See* C. WRIGHT, *supra* note 148, at 134. *See also* United Steelworkers of America, AFL-CIO v. R.H. Bouligny, Inc., 382 U.S. 145 (1965).

152. 28 U.S.C. § 1404 (1982) provides: "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought." *See, e.g.*, Van Dusen v. Barrack, 376 U.S. 612 (1964).

153. *United Steelworkers*, 382 U.S. at 150.

154. *See, e.g.*, Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974). The *Eisen* case was litigated in the federal courts for 10 years. The case was appealed within the federal court system three different times. Upon the third appeal, the United States Supreme Court ordered the case dismissed. The first appeal was known as *Eisen I*, 370 F.2d 119 (2d Cir. 1966) *cert. denied*, 386 U.S. 1035 (1967). The second appeal was known as *Eisen II*, 391 F.2d 555 (2d Cir. 1968). In *Eisen III*, the Supreme Court dismissed the case. 417 U.S. 156 (1974).

155. *See* C. WRIGHT, *supra* note 148, at 629.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

federal judges' power to comment on the evidence, federal courts are more capable of justly managing complex litigation such as securities suits than are the state courts.[160]

A fourth beneficial consequence of the *Landreth* decision is that the decision encourages nationwide commercial uniformity. Under the old sale of business doctrine, each state had to promulgate its own blue sky laws to regulate transactions involving the sale of one hundred percent of the stock of a business.[161] Subjecting multistate corporations to various and conflicting securities laws creates an uncertain business environment and inhibits investment and the free flow of commerce. "No nation ever prospered in commerce," Justice Story wrote in 1839, "until its own policy became settled" and its law became "uniform."[162] More recently, one commentator has noted that the sale of business doctrine creates "a minefield of contradictions and confusion" once courts deviate from the certainty of federal securities laws.[163] Indeed, the Securities and Exchange Commission has stated that the sale of business doctrine results in "the inability of parties to a transaction to predict whether the securities laws are applicable [and] raises the cost of economic transactions . . . spawns litigation, and in general benefits neither the parties nor the courts."[164]

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160. Charles Wright has noted that "the federal courts are so much better than the state courts that it is desirable to channel as many cases as possible to the federal court." C. WRIGHT, *supra* note 148, at 134.

161. Under the doctrine, existing federal laws would not apply to sales of one hundred percent of the stock of a business since these transactions do not involve a "security" as defined in the Securities Acts. Consequently, state legislatures are left to fill this legal void.

162. J. STORY, THE MISCELLANEOUS WRITINGS OF JOSEPH STORY 224 (W. Story ed. 1852).

163. *See* Darrell, *supra* note 141, at 26.

164. Brief for the Securities and Exchange Commission as *amicus curiae* Supporting Petitioner at 21, *Landreth*, 105 S. Ct. at 2297. *See also* Ruefenacht v. O'Halloran, 737 F.2d 320, 332 (3d Cir. 1983).

In arguing for the rejection of the sale of business doctrine, one commentator has stated:

> By making the definition of a security as pliable as putty, to be molded to the facts of the particular case at hand, the courts have gone beyond merely 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 effects of the courts in 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. Only by aligning the definition of a security with the statutory framework for the registration and regulation of securities can the sale of business issue be logically resolved.

Darrell, *supra* note 141, at 63.

C. The True Spirit of the Securities Acts

The *Landreth* decision conforms to both the legislative history and policy of the Securities Acts. A minority of courts have concluded from the legislative history of the Securities Acts that Congress did not intend to extend federal securities laws to the sales of one hundred percent of the stock of a business.[165] This minority believes that large investors do not need the protection of federal securities laws.[166]

However, a majority of the federal courts of appeals have analyzed the securities laws and have more appropriately concluded that the sale of one hundred percent of the stock of a business was intended to be within the Acts' anti-fraud and disclosure provisions.[167] Moreover, as the Securities and Exchange Commission maintained in *Golden*,[168] "there are strong reasons for concluding that the application of the federal securities laws should not depend on whether the purchaser of stock buys a small interest, a controlling interest, or all the stock of a corporation."[169]

Congress hastily drafted the Securities Acts of 1933 and 1934 in reaction to a sudden and drastic stock market crisis.[170] Consequently, the legislative history is not complete, and Congress was silent on the sale of business issue.[171] However, an analysis of Congressional debate demonstrates that "the legislative history provides no justification for the sale of business doctrine."[172]

A House Report[173] accompanying the 1933 Act states that for

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165. *See supra* notes 19-21.

166. *See* Brief for Respondents at 4, 6, *Landreth*, 105 S. Ct. at 2297.

167. *See supra* notes 22-25.

168. 678 F.2d at 1139.

169. Brief for the Securities and Exchange Commission as *amicus curiae* at 3, Golden v. Garafalo, 678 F.2d 1139 (7th Cir. 1982).

170. *See supra* notes 31-38 and accompanying text.

171. *See* Brief, *supra* note 164, at 13.

172. *Id.*

173. The entire text of the House Report concerning the definition of a security under § 2(1) is as follows:

> Paragraph (1) defines the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security. The definition is again comprehensive enough to bring within its terms certificates of deposit issued by protective committees. It also includes warrants or rights to subscribe to a security, so that the control exerted by this bill commences with the initiation of any scheme to sell securities to the public.

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

the purpose of defining a security under section 2(1), the term "security" is intended to be defined "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."[174] As the Supreme Court in *Landreth* concluded, the sale of one hundred percent of the stock of a business falls within the ordinary concept of a security.[175] The House Report also reports that Congress intended the definition to be inclusive, "broad," and "comprehensive."[176] Furthermore, the House Report did not contain any language limiting the definition of a "security."[177]

Section 2(1) of the 1933 Act lists fifteen separate definitions of the term "security."[178] If a stock transaction involves any one of these listed items, then the transaction involves a security for the purposes of the Securities Acts. Section 2(1), however, does not describe any item or transaction that does not fall within the Act's definition of a security.[179] The fact that Congress made this exhaustive attempt to provide a comprehensive definition of a security while not making any attempt to limit the definition shows that Congress intended to include within the coverage of the federal securities laws almost all stock transactions. Therefore, Congress certainly intended a stock transaction as typical as the sale of all the stock of a business to be within the ambit of the section 2(1) definition of a "security" for the purpose of the federal securities laws.

Section 4 of the 1933 Act exempts several transactions from the Act's coverage.[180] Although section 4 provides an exhaustive list of exemptions,[181] it does not exempt sales of one hundred percent of the stock of a business. In discussing section 4, the House Report accompanying the Act expressly stated that "every security and transaction not specifically exempted by the terms of the [Act] should be kept within its scope."[182] The House Report, therefore,

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174. *Id.*
175. 105 S. Ct. at 2304.
176. *Id.*
177. *Id.*
178. 15 U.S.C. § 77b(1) (1982). For the text of § 2(1), *see supra* note 6.
179. *Id.*
180. 15 U.S.C. § 77d (1982). For a discussion of § 4, *see supra* note 3.
181. *Id.*
182. H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933). The House Report deemphasizes any notion of limiting the number of transactions which would involve a "security" as defined in § 2(1) of the Act. Section 3 of the Act excludes classes of securities from the Act's

indicates that the sale of business doctrine should be rejected since section 4 does not exempt sales involving all the stock of a business.

The legislative history and policy[183] behind the Securities Acts indicate that Congress intended the federal securities laws to provide comprehensive protection for investors. However, prior to *Landreth*, some courts[184] used the sale of business doctrine to unintentionally undermine the statutory purposes of the Securities Acts. As a result, before the Supreme Court decided *Landreth*, investors were left without federal protection against fraud in transactions involving all of the stock of a business.

Investors stripped of federal securities law protection still have state law protection against fraud. State law offers stock investors two forms of protection: the common law and the state blue sky laws. However, the common law tort of misrepresentation

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coverage. 15 U.S.C. § 77c (1982). Section 4 excludes transactions from the Act's coverage. 15 U.S.C. § 77d (1982). For a discussion of §§ 3 and 4, *see supra* note 3. Sections 3 and 4 represent all the securities that Congress intended to exempt from the Act's coverage. The House Report accompanying the Act stated very little about these exemptions, thereby indicating the small role that Congress wanted the exemptions to have in the application of federal securities laws. Consequently, it follows that Congress did not intend to exclude sales of one hundred percent of the stock of a business from the provisions of the Securities Acts. The House Report's entire discussion of the exemptions of §§ 3 and 4 is as follows:

> The exemption sections, 3 and 4, exempt, among other transactions in securities, transactions by individuals; the execution by brokers of customer's orders in the open market; transactions by a dealer in securities not connected by time or circumstance with distribution of a new offering; securities issued in a reorganization subject to the approval of a court; certificates issued by a receiver or by a trustee in bankruptcy, with the approval of a court; short-term commercial paper; general obligations of the Federal Government and its corporate instrumentalities, of national banks, of the Federal Reserve banks, of State banks (as suggested by a committee amendment), and the States and their political subdivisions; railroad securities subject to the jurisdiction of the Interstate Commerce Commission; insurance policies subject to the supervision of a State insurance commissioner; and the securities of a nonprofit corporation and of certain building and loan associations. The Commission is given a further discretionary power *carefully limited to* exempt additional transactions and securities where the aggregate amount of the offering does not exceed $100,000. This power is deemed necessary for the effective administration of the bill, but is expected to be used only in a *sparing manner*, which keeps in mind the prima facie requirement that *every* security and transactions *not specifically exempted* by the terms of the bill should be kept within its scope.

H.R. REP. No. 85, 73d Cong., 1st Sess. 6-7 (1933) (emphasis added).

183. *See* Brief, *supra* note 169, at 2 and accompanying text. *See also supra* notes 170-82 and accompanying text.

184. *See supra* note 17.

provides little effective protection for stock investors.[185] The most notable deficiency of the common law is that it only provides an after-the-fact remedy because the common law does not mandate an affirmative duty to disclose information[186] as does the 1933 Act.[187]

Moreover, the nature of modern securities transactions renders the common law an ineffective tool to protect investors. In the course of a sale of all of a corporation's stock, business brokers, accountants, attorneys, and the principals to the transaction make hundreds of representations concerning the transaction. Some of these representations are written; some are oral. Others are made in documents which contain legally binding liability disclaimers. As a practical matter, in a complex securities transaction the plaintiff often cannot meet his burden of proving common law misrepresentation. Under the Securities Acts, however, the rights, responsibilities and the potential liability of all the parties in a securities transaction are clearly defined in detail, thereby resulting in *de facto* strict liability to categories of defendants upon proof of fraud in a securities transaction.[188]

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185. *See* 3 L. Loss, *supra* note 2, at 1431; W. Prosser, Law of Torts, § 107 (4th ed. 1971); Shulman, *Civil Liability and the Securities Act*, 43 Yale L. J. 227 (1933) (which provides a thorough discussion of common law remedies in securities suits).

186. *See supra* note 140.

187. For the text and a discussion of the Act's disclosure requirements, *see supra* note 41.

188. For example, § 11 of the Act states in detail who can be liable for violating its provisions. 15 U.S.C. § 77k(a) (1982). *See supra* note 43 for the text of § 11. Among the potential defendants in a civil suit under § 11 are: (1) the issuer's board of directors; (2) accountants; (3) engineers; (4) appraisers; (5) experts who have given their opinion in the preparation of the registration statement; (6) underwriters; and (7) anybody who signed the registration statement. 15 U.S.C. § 77k(a) (1982).

Section 6(a) of the Act provides a list of persons who must sign the registration statement. Section 6(a) provides:

> Any security may be registered with the Commission under the terms and conditions hereinafter provided, by filing a registration statement in triplicate, at least one of which shall be signed by each issuer, its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors or persons performing similar functions (or, if there is no board of directors or person performing similar functions, by the majority of the persons or board having the power of management of the issuer), and in the case the issuer is a foreign or Territorial person by its duly authorized representative in the United States; except that when such registration statement relates to a security issued by a foreign government, or political subdivision thereof, it need be signed only by the underwriter of such security.

15 U.S.C. § 77f(a) (1982).

State blue sky laws also cannot protect investors in transactions excluded from federal protection because of the sale of business doctrine.[189] State legislatures, as a whole, are not devoted to promulgating strong blue sky laws.[190] Even Article 2 of the Uniform Commercial Code, which provides uniform laws concerning the sales of goods in forty-nine states, expressly excludes securities from its provisions.[191] In addition, one commentator has noted that some state legislatures are reluctant to provide effective enforcement mechanisms for the blue sky laws that they legislate.[192]

State governments' inability to regulate gigantic multistate corporations further incapacitates blue sky laws.[193] The interstate nature of modern business has actually created a disincentive to regulate stock transactions because multistate corporations penalize states which impose stringent civil liability for fraudulent practices.[194] These penalties include corporate refusal to locate or provide jobs in states with effective securities laws.[195]

The Supreme Court's decision in *Landreth* also conforms to the reasonable expectations of the parties to the transaction. A party in a transaction involving one hundred percent of the stock of a business will reasonably expect that he has federal securities law protection. In *Landreth*, the United States Supreme Court addressed this concern. Although the Supreme Court concluded in *Forman* that labeling a transaction a sale of "stock" does not automatically invoke the federal securities laws,[196] the Court in *Lan-*

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189. For the reasons why state blue sky laws are ineffective, *see infra* notes 190-95 and accompanying text. *See also* 1 L. Loss, *supra* note 2, at 105-07.

190. 1 L. Loss, *supra* note 2, at 105-07.

191. U.C.C. § 2-105(1) (1975).

192. *See* 1 L. Loss, *supra* note 2, at 106.

193. *See Hearings, supra* note 31.

194. Professor Karmel describes the problem as follows:

> The giant modern corporation, which is often national or even international in scope, is an entity without geographical loyalties. Since it is easily incorporated under the laws of any state in the United States, its management will select as the corporation's legal domicile that jurisdiction whose law most adequately conforms to its own regulatory preferences. Because this selection involves the payment of significant sums of corporate franchise fees and taxes to financially squeezed state governments, there is a competition among the states to make their corporate laws the most attractive to management. The result is a body of law that allows corporations great latitude in their structure and governance and allows directors great freedom in their management of a corporation's business and affairs.

R. Karmel, Regulation by Prosecution 204 (1st ed. 1982).

195. *Id.*

196. 421 U.S. at 848.

dreth indicated that in a situation involving the sale of one hundred percent of the "stock" of a business it is "much more likely . . . that an investor would believe he was covered by the federal securities laws."[197]

Related to this reasonable expectation concept is the "freedom of contract" doctrine[198] which lies at the very foundation of American contract law.[199] Under the freedom of contract doctrine, parties to a contract are free to include any provision that they desire in their agreement.[200] As long as the contract terms are lawful and do not violate public policy, the courts will enforce the contract according to the results of the parties' bargaining.[201]

The sale of the business doctrine contradicted the freedom of contract doctrine. By contracting to purchase all the stock of a business, the buyer, who has intentionally structured his transaction as a securities purchase, has contracted for federal securities law protection.[202] Under the freedom of contract doctrine, the buyer is entitled to this protection. If, on the other hand, the buyer chooses to purchase a business in a nonstock transaction such as a sale of all the business's assets,[203] then, pursuant to the parties'

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197. 105 S. Ct. at 2303.

198. *See* J. CALAMARI & J. PERILLO, CONTRACTS § 1-3, at 4 (2d ed. 1977). The doctrine can be summarized as follows: "Contract law is premised upon a model consisting of two alert individuals, mindful of their self interest, hammering out an agreement by a process of hard bargaining." *Id.* at 6.

199. *Id.* at 5. Williston has written that "Adam Smith, Ricardo Bentham, and John Stuart Mill successively insisted on freedom of bargaining as the fundamental and indispensable requisite of progress. . . ." Williston, *Freedom of Contract*, 6 CORNELL L. Q. 365, 366 (1921).

200. J. CALAMARI & J. PERILLO, *supra* note 198, at 5.

201. *Id.* at 5-6.

202. *See* Darrell, *supra* note 141, at 42.

In Occidental Life Ins. Co. v. Pat Ryan & Associates, 496 F.2d 1255 (4th Cir. 1974) the Fourth Circuit Court of Appeals recognized this freedom-of-contract concept in rejecting the sale of business doctrine. In *Occidental*, the plaintiff, an insurance company, sold one hundred percent of the stock of its wholly owned subsidiary to the defendants. *Id.* at 1259. The defendant counterclaimed under sections 12(2) and 17(a) of the 1933 Act and Rule 10b-5 of the 1934 Act. *Id.* at 1260 n.1. The plaintiff moved to dismiss the counterclaim alleging that under the sale of business doctrine the case did not involve the sale of a "security" as defined in the Securities Act. *Id.* at 1261. On appeal, the Fourth Circuit affirmed the trial court's denial of the plaintiff's motion to dismiss the counterclaim and suggested that it might have dismissed the counterclaim had the transfer of ownership been accomplished through a sale of assets rather than through the sale of stock. *Id.* at 1262. The *Occidental* court also noted that it could not find any reason for reading the Securities Acts in a manner that provides coverage to the small investor, but not to the large investor capable of buying all of a company's stock. *Id.*

203. This transaction is known as an "asset acquisition." For a discussion of asset ac-

expectations, the federal securities laws would not apply to the transaction.[204] In *Landreth*, the Supreme Court's decision upheld this freedom of contract analysis when it decided that the sale of one hundred percent of the stock of a business was the sale of a "security" as defined in the Securities Acts.

CONCLUSION

Prior to *Landreth*, the courts of appeals had conflicting views over validity of the sale of business doctrine. A minority of judicial decisions in the United States Courts of Appeals followed the sale of business doctrine. As the United States Supreme Court's decision in *Landreth* indicates, the sale of business doctrine incorrectly defined the scope of the federal securities laws. In *Landreth*, the Supreme Court rejected the sale of business doctrine and all the harmful consequences that the doctrine imposed upon the investing public.

The *Landreth* decision protects investors and aids plaintiffs in securities fraud cases in four ways. First, the decision ensures that purchasers of one hundred percent of the stock of a business will have access to the material information relating to the transaction. Second, the decision allows defrauded investors the civil relief provided for in the Securities Acts. Third, the decision provides investors with a federal forum in which to litigate their fraud claims. Fourth, the decision encourages investment through the uniform application of securities laws.

Finally, the *Landreth* decision also conforms to the legislative history and the fundamental policy behind the Securities Acts. In summary, the Supreme Court in *Landreth* laid to rest the misguided sale of business doctrine and correctly reestablished the framework through which defrauded stock investors may pursue judicial remedies.

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quisition, *see* W. PAINTER, BUSINESS PLANNING 659-60 (2d ed. 1984).

204. There are some minor differences between the two forms of business acquisitions. For example, in an asset acquisition, the liabilities of the liquidating corporation are not typically assumed by the buyer. In the sale of all the stock of a business, the buying shareholders assume the corporate liabilities to the extent of their stockholdings. Additionally, there may be some transfer taxes in a sale of assets. These taxes differ in each state. *See* Snell, *Reflections on the Practical Aspects of "The Sale of Corporate Control,"* 1972 DUKE L. J. 1193 (1972); Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1963).