Spring 1986

Securities Regulation - Sale of Business Doctrine: Landreth Timber Company v. Landreth

James E. Burke

SECURITIES REGULATION—Sale of Business Doctrine: *Landreth Timber Company v. Landreth*

I. INTRODUCTION

In *Landreth Timber Company v. Landreth*,[1] the United States Supreme Court addressed the issue of whether the sale of all the stock in a closely-held corporation was a securities transaction and therefore subject to the antifraud provisions of the federal securities laws ("Acts").[2] The courts of appeals and commentators[3] had split over this question. The Seventh,[4] Ninth,[5] Tenth,[6] and Eleventh[7] Circuits had recognized a "sale of business" exception to the Acts' coverage. These circuits had looked through the form of challenged transactions and examined the underlying economic substance. They reasoned that purchasers were in reality buying a business. Since sales of businesses were not securities transactions, stock sales designed to accomplish this same end should similarly not be transactions subject to the Acts' coverage.[8] Furthermore, purchasers who assumed control of a business were not the kind of passive investors the Acts were designed to protect.[9]

In contrast, the Second,[10] Third,[11] Fourth,[12] Fifth,[13] and Eighth[14] Cir-

1. 105 S.Ct. 2297 (1985).

2. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (1976)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1933) (codified as amended at 15 U.S.C. §§ 78a-78kk (1976)). *See infra* notes 32-34 and 64 for text in pertinent part.

3. *Compare, e.g.* Seldin, *When Stock Is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 BUS.LAW. 637 (1982); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Securities Transaction*, 57 N.Y.U. L. REV. 225 (1982) (both supporting the doctrine) *with, e.g.* Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When Is Stock Not a Security?*, 61 N.C.L. REV. 393 (1983); Comment, *A Criticism of the Sale of Business Doctrine*, 71 CALIF. L. REV. 974 (1983) (both rejecting the doctrine).

4. Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied* 451 U.S. 1017 (1981).

5. Landreth Timber Co. v. Landreth, 731 F.2d 1348 (9th Cir. 1984), *rev'd* 105 S.Ct. 2297 (1985).

6. Christy v. Cambron, 710 F.2d 669 (10th Cir. 1983); Chandler v. Kew, Inc., 691 F.2d 443 (10th Cir. 1977).

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

8. *See, e.g. Landreth*, 105 S.Ct. at 2301.

9. *See, e.g.* King v. Winkler, 673 F.2d 342, 346 (11th Cir. 1982); Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983). *See also infra* text accompanying notes 47-61.

10. Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227 (2d Cir. 1982); Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982).

11. Ruefenacht v. O'Halloran, 737 F.2d 320 (3rd Cir. 1984), *aff'd.*, 105 S.Ct. 2308 (1985).

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

cuits rejected this "sale of business" exception, holding that the Acts applied whenever an instrument called "stock" was transferred, if that stock possessed the characteristics commonly associated with stock.[15] These jurisdictions had taken a literal approach, reasoning that since stock is one of the instruments defined as a security by the Acts,[16] the transactional context of the stock transfer was not relevant.[17]

Landreth was the United States Supreme Court's first ruling on the "sale of business" doctrine.[18] In its decision, the Court adopted a literal approach to the Acts' coverage and held that the *Landreth* stock was a "security."[19] The Court stated that the "sale of business" doctrine did not apply.[20] This decision is important for all practitioners who work with buyers and sellers of businesses because the *Landreth* holding imposes potential federal securities law liabilities in situations where even the smallest closely-held business is transferred through a stock sale. This Note discusses the *Landreth* Court's rationale and the future impact of the decision on securities law.

II. STATEMENT OF THE CASE

Landreth and his sons (hereinafter Landreth) were the sole shareholders in a lumber business they operated in Tonasket, Washington.[21] A small group of investors, backed principally by Dennis and Bolten,[22] expressed

(1979); Occidental Life Ins. Co. v. Pat Ryan Assocs. Inc., 496 F.2d 1255 (4th Cir.), *cert. denied* 419 U.S. 1023 (1974).

13. Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983).

14. Cole v. PPG Indus., 680 F.2d 549 (8th Cir. 1982) (interpreting Arkansas law).

15. *See infra* text accompanying note 58.

16. *See infra* text accompanying note 64.

17. *See, e.g.*, Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982), "We think the term 'stock' in the definition of 'security' in the '33 and '34 Acts should be read to include instruments, such as these, which have the characteristics associated with ordinary, conventional shares of stock." (rejecting the sale of business doctrine); Coffin v. Polishing Machines, Inc., 596 F.2d 1202, 1204 (4th Cir. 1979), "Absent some showing that ordinary corporate stocks are other than what they appear to be, we need not consider whether an investor will derive his profit partly from his own efforts." (rejecting the sale of business doctrine); Glick v. Campagna, 613 F.2d 31, 35 n.3 (3rd Cir. 1979), "[A] literal reading of the statute and governing precedent require that we consider this case on the merits." (holding that sale of 50% interest in corporation to other 50% owner, structured through stock sale was not a sale of a partnership interest, but a securities transaction within scope of the Acts.)

18. Gould v. Ruefenacht, 105 S.Ct. 2308 (1985) is a companion case to *Landreth*. *See infra* note 97.

19. 105 S.Ct. at 2308.

20. *Id.*

21. 105 S.Ct. at 2300.

22. Dennis was a senior partner and tax attorney at the Boston law firm of Hale and Dorr. He had extensive practical experience with business acquisitions and was co-founder, officer and director of Standex Corporation, a Fortune 500 firm whose shares are traded on the New York Stock Exchange. He was involved in numerous business sales, both as counsel for buyers and sellers of businesses and also as a purchaser. Bolten had been the honorary chairman of the board and a major shareholder

interest in purchasing the business.[23] They conducted extensive pre-purchase investigations, including visits to the sawmill and assistance from a sawmill engineering firm, a certified public accountant, and a bank officer who was an expert on sawmill properties.[24] Landreth insisted on a sale of stock rather than a sale of the corporation's assets,[25] and the parties negotiated a stock purchase agreement for 100% of the lumber company stock.[26] Landreth declined an offer to continue in a management position[27] and his post-closing role was purely advisory.[28] The business did not live up to purchasers' expectations;[29] Landreth Timber Company[30] (hereinafter the Company) was unprofitable, sold the sawmill at a loss, and eventually went into receivership.[31]

Landreth Timber Company filed suit in the Western District of Washington seeking rescission of the stock sale and $2,500,000 in damages.[32] The Company claimed that Landreth had widely offered and sold stock

---

in Standex. Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit at 2, *Landreth Timber Co. v. Landreth*, 731 F.2d 1348 (9th Cir. 1984). (Hereinafter "Brief in Opposition.")

23. Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1350 (9th Cir. 1984).

24. 105 S.Ct. at 2301. *See also* Brief in Opposition at 2-3.

25. 731 F.2d at 1350. Although the transaction could "easily" have been structured as an asset sale, Landreth preferred a stock sale for tax purposes. Brief in Opposition at 3.

26. 105 S.Ct. at 2301.

27. 731 F.2d at 1350.

28. *Id.* See also Brief in Opposition, Appendix C, Admissions No. 32, 38, 42-49, 56, 59, 61, 62, 64-67, 72-81, 83, 85, 87.

29. 105 S.Ct. at 2301.

30. After the purchase, Dennis and Bolton assigned all of the stock to B & D Company, a Delaware corporation formed for the purpose of purchasing the Landreth stock. B & D Corporation then merged with the lumber company to form Landreth Timber Company, the petitioner. 105 S.Ct. at 2301.

31. 731 F.2d at 1350.

32. *Id.* Section 12 of the Securities Act of 1933 provides:

> Any person who—
>
> (1) offers or sells a security in violation of section 77e of this title [section 5], or
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 77c [section 3], other than paragraph (2) of subsection (a) of said section), 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 the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or ommission), 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. § 77l.

without registering it as required by the Securities Act of 1933.[33] It also alleged that Landreth had negligently or intentionally made misrepresentations and had failed to state material facts regarding the worth and prospects of the timber company, in violation of the Securities Exchange Act of 1934.[34]

Landreth moved for summary judgment on the ground that the sale of the lumber company was not a transaction within the purview of the Securities Act of 1933 or the Securites Exchange Act of 1934 because, under the "sale of business" doctrine, the buyers had not purchased a "security" within the meaning of those Acts.[35] The district court granted Landreth's motion and dismissed the complaint for lack of federal subject matter jurisdiction.[36] The district court noted that the stock possessed all

33. 731 F.2d at 1350. Section 5(c) of the Securities Act of 1933 states:

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security. . .

15 U.S.C. § 77c.

34. 731 F.2d at 1350. Section 10 of the Securities Exchange Act of 1934 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—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j.

Rule 10b-5, promulgated by the SEC to implement Section 10 states:

> 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,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact 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,
>
> (3) 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.

35. 105 S.Ct. at 2301. *See infra* text accompanying note 64.

36. 105 S.Ct. at 2301 (citing Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, *Landreth Timber Co. v. Landreth*, 731 F.2d 1348 (9th Cir. 1984), Appendix at 13a). (Hereinafter "Petition for Cert.") The district court opinion is unpublished but appears in the appendices to the petitions for and brief in opposition to certiorari.

Landreth Timber is a typical "sale of business" doctrine case, in that the question of whether there is a security is jurisdictional. 28 U.S.C. § 1331 (1982) grants federal jurisdiction for civil actions "arising under the Constitution, laws, or treaties of the United States." If a security is involved, a plaintiff can bring an action in federal court under the federal securities laws. If the challenged instrument is not a security, there is no federal jurisdiction unless other jurisdictional requirements are satisfied (*e.g.* 28 U.S.C. § 1332 (1982) (diversity of citizenship and the amount in controversy exceeds $10,000 exclusive of interest and costs)).

of the characteristics of conventional stock and that the term "stock" was one of the enumerated instruments in the federal statutes.[37] However, the court held that the federal securities laws did not apply to this sale of 100% of the stock of a closely held corporation.[38] The district court ruled that stock could not be considered a "security" unless the purchaser had entered into the transaction with the anticipation of earning profits derived from the efforts of others.[39] Finding that managerial control had passed to the purchasers, the *Landreth* transaction was a commercial venture outside of the scope of the Acts, rather than a typical investment.[40]

On appeal, the Court of Appeals for the Ninth Circuit affirmed.[41] The United States Supreme Court granted certiorari[42] because the circuits were divided over the applicability of the federal securities laws when a business is sold by the transfer of 100% of its stock.[43] In an 8-1 decision, the Supreme Court reversed the Ninth Circuit.[44]

III. DISCUSSION AND ANALYSIS

The issue that the Court faced in *Landreth* was whether the sale of all of Landreth's stock in a lumber business was a securities transaction and, therefore, subject to the antifraud provisions of the federal securities laws. The Court also necessarily had to rule on the applicability of the "sale of business" doctrine, because that doctrine had formed the basis of the Ninth Circuit's decision.

The Supreme Court used a dual approach to hold that the Landreth stock was a security and that the "sale of business" doctrine did not apply. First, the Court literally interpreted the Acts' language, declaring that normal stock will always be considered a security. Second, the Court justified this bright line construction by examining the policies underlying the Acts. Following a brief review of the "sale of business" doctrine and its origins, this Note analyzes the Supreme Court's rejection of that doctrine in *Landreth*.

A. The Sale of Business Doctrine

The "sale of business" doctrine posits that a sale of a business structured through the sale of 100% of its stock is not a transaction in securities for purposes of the Acts.[45] While "stock" is one of the instruments listed as

37. 105 S.Ct. at 2301 (citing Petition for Cert, Appendix at 13a).
38. *Id.*
39. *Id. See also infra* text accompanying notes 47-61.
40. 105 S.Ct. at 2301.
41. 731 F.2d at 1353.
42. 105 S.Ct. 427 (1984).
43. 105 S.Ct. at 2301.
44. Justice Powell delivered the opinion of the Court, 105 S.Ct. 2297, from which Justice Stevens dissented, *Id.* at 2312.
45. *See, e.g.*, Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1351 (9th Cir. 1984); King v. Winkler, 673 F.2d 342, 345 (11th Cir. 1982).

a security in the definitional sections of the Acts, those sections are preceded by the phrase "unless the context otherwise requires."[46] Jurisdictions accepting this doctrine have interpreted a sale of all of a corporation's stock to be a context that requires the stock at issue not be considered a security.[47] These jurisdictions hold that the only context in which a security is present is when there is an investment in a common enterprise with the expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[48] These jurisdictions derive this method of analysis directly from two prior United States Supreme Court cases: *SEC v. W.J. Howey Co.*[49] and *United Housing Foundation, Inc. v. Forman.*[50]

In *SEC v. W.J. Howey Co.* the Supreme Court held that an unusual instrument was an "investment contract" subject to the federal securities laws.[51] The instrument challenged was a land sales contract for citrus groves coupled with a service and management contract to maintain the acreage.[52] The Court developed an economic reality test for an "investment contract": a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[53] Applying this test to the instrument, the *Howey* Court elevated substance over form and examined the underlying economic realities to determine that the instrument was an investment contract subject to the Acts.[54]

Almost thirty years later, the Court again applied its economic reality test to an unconventional instrument in *United Housing Foundation, Inc.*

46. 15 U.S.C. § 77b (Securities Act of 1933); 15 U.S.C. § 78c(a) (Securities Exchange Act of 1934). *See infra* text accompanying note 64.

47. *See, e.g.*, Chandler v. Kew, 691 F.2d 443 (10th Cir. 1977); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir. 1981), *cert. denied* 451 U.S. 1017 (1981); King v. Winkler, 673 F.2d 342 (11th Cir. 1982). In some cases, a sale of a "controlling" block of the stock will invoke the doctrine. *See, e.g.* Colson v. Bertsch, 586 F.Supp. 1289 (D.N.J. 1984) (35%-49% stock interest); Cadiz v. Jiminez, 579 F.Supp 1176 (D.P.R. 1983) (14% stock interest); Oakhill Cemetery v. Tri-State Bank, 513 F.Supp. 885 (N.D.Ill. 1981) (50% stock interest not security if owner has corporate control). *See also* Ruefenacht v. O'Halloran, Civ. No. 80-1097 (D.N.J. Apr. 15, 1983) (50% stock interest), *rev'd.* 737 F.2d 320 (3rd Cir.), *aff'd. sub nom.* Gould v. Ruefenacht, 105 S.Ct. 2308 (1985). *See infra* note 103 for discussion of *Gould*.

48. *See, e.g.*, King v. Winkler, 673 F.2d 342, 346 (11th Cir. 1982) ("The purchasers' expectation of profit would come from their own efforts, not those of others. This was not a security transaction or investment contract intended to be governed by the Federal Securities Acts."); Christy v. Cambron, 710 F.2d 669, 672 (10th Cir. 1983) ("It is clear that plaintiff's shares in the disco were not 'securities' within the meaning of the federal securities law. The attribute of a security is that it represents an investment in a venture which derives profits from the entrepreneurial or managerial efforts of others.").

49. 328 U.S. 293 (1946).

50. 421 U.S. 837 (1975).

51. 328 U.S. at 299.

52. *Id.* at 295-96.

53. *Id.* at 298-99.

54. *Id.* at 299.

v. Forman.[55] The Court determined that interests called "stock" in a non-profit housing corporation were not securities covered by the Acts.[56] Although the instruments were called "stock," the Court reasoned that it must determine whether the "stock" possessed "some of the significant characteristics typically associated with" stock.[57] The characteristics usually associated with common stock are: 1) the right to receive dividends contingent upon an appropriation 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.[58] Since the instruments involved bore none of the characteristics of typical stock, they were not securities for the purposes of the Acts.[59]

In the second part of the *Forman* opinion, the Court analyzed whether the "stock" could qualify as an "investment contract," one of the catch-all instruments listed in the definitional section of the Acts.[60] Applying the economic reality test devised by the *Howey* Court, it determined that the "stock" was also not an investment contract and, therefore, not a security.[61]

Thus, by applying the *Howey* economic reality test to an unconventional instrument, the *Forman* court narrowed the Acts' scope. *Forman,* however, left an unanswered question: whether the economic reality test is applicable only when an instrument does not first satisfy a normal attributes test, or whether it should be applicable to all cases. Jurisdictions accepting the "sale of business" doctrine read *Forman* as supporting an economic reality test in all cases; jurisdictions rejecting the doctrine read *Forman* as requiring an economic reality test only if an unconventional instrument was involved.

B. Statutory Analysis in Landreth

The Supreme Court in *Landreth* implicity answered the question left unanswered in *United Housing Foundation, Inc. v. Forman*.[62] It ruled that

55. 421 U.S. 837 (1975).

56. *Id.* at 860. Tenants of the non-profit housing project had to purchase shares of "stock" in the housing corporation in order to lease apartments. *Id.* at 842. The number of shares to be purchased was based on the number of rooms in the apartment. *Id.* The shares did not pay dividends based on the profitability of the corporation, nor could they appreciate in value since a tenant was forced to offer them back to the corporation for the original purchase price if the tenant were vacating the housing project. *Id.* Finally, the shares carried no voting privileges in proportion to the number of shares owned. *Id.*

57. *Id.* at 851.

58. *Id.*

59. *Id.*

60. *Id.* at 851-58. *See infra* text accompanying note 64 for statute in pertinent part.

61. *Id.* at 858.

62. 421 U.S. 837 (1975).

the Acts would be interpreted literally to determine if the *Landreth* stock was a security.[63] Section 2 of the Securities Act of 1933 states:

> When used in this subchapter, unless the context otherwise requires—
> (1) The term "security" means any note, stock, treasury stock, bond, . . . investment contract . . . or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, termporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[64]

The Acts define a "security" as including "stock." Therefore, the face of the definition shows that "stock" is to be considered a "security."[65]

To justify its literal reading of the Acts, the *Landreth* Court stated that the "context" of the transaction was "the sale of stock in a corporation."[66] This context was typical of the context in which the Acts normally applied.[67] The Court emphasized that because the context was a typical scenario in which the Acts would normally apply, an investor would reasonably believe in the Acts' applicability.[68] The Supreme Court refused

---

63. 105 S.Ct. at 2302-03.

64. 15 U.S.C. § 77b(1).

Section 3(a)(10) of the Securities Exchange Act of 1934 states:

> (a) When used in this chapter, unless the context otherwise requires—
> (10) The term "security" means any note, stock, treasury stock, bond . . . investment contract . . . or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing . . .

15 U.S.C. § 78c(a)(10).

The Supreme Court has held that the definitions of "security" in the 1933 and 1934 acts are virtually identical and will be treated as such in its decisions dealing with the scope of the term. Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975).

65. 105 S.Ct. at 2302.

66. *Id.* at 2303. This effectively overrules lower court cases characterizing the context of a Landreth-type sale (i.e. sale of all of a corporation's stock) as a sale of a business, not a sale of a security.

In dissent, Justice Stevens believed that the characteristics of the entire transaction are relevant in determining whether a transaction in stock is covered by the Acts, because these considerations are valid in determining if other instruments amount to transactions in securities. *Landreth*, 105 S.Ct. at 2313. (Stevens, J., dissenting). The decision to structure a transaction through the sale of stock rather than the sale of assets usually depends on matters irrelevant to the federal securities laws, such as tax liabilities, assignability of intangible assets, etc. *Id.* If Congress had intended to provide a remedy for every fraud in the sale of a business or its assets, it would not have permitted the parties to bargain over federal jurisdiction. *Id.* For example, if the Landreth sale had been structured as an asset sale, there would be no security transaction and therefore no resulting federal jurisdiction under the Acts. After *Landreth*, a purchaser can guarantee federal jurisdiction simply by structuring a business sale as a stock transfer.

67. 105 S.Ct. at 2303.

68. *Id.* The Court contrasted *Landreth* with *Forman*. In *Forman*, purchasers of shares in a non-profit cooperative housing project would not have reasonably believed that their transactions were governed by the Acts. *Id* at 2302.

to analyze the economic reality underlying the *Landreth* transaction; the district court had determined that the *Landreth* stock possessed all of the typical characteristics of common stock.[69] It was, therefore, a security.[70]

As additional justification for its literal approach, the Court relied on Congress' intent to protect investors.[71] Holding that the *Landreth* transaction was covered by the Acts would comport with Congress' remedial purpose in passing the legislation.[72] The Court acknowledged that Congress did not intend to provide a federal remedy for all fraud,[73] but stated that "it would improperly narrow" Congress' broad definition of security if it exempted the *Landreth* stock from coverage, because stock is specifically included in the list of instruments defined as security.[74]

Although it stated that the statutory analysis was sufficient to dispose of the case, the Court proceeded to address concerns raised by Landreth and the Ninth Circuit.[75] First, Landreth urged the Court to rule that its prior decisions required that courts look beyond the label "stock" and the characteristics of the instruments involved to determine whether application of the Acts was mandated by the economic substance of the transaction.[76] Landreth argued that an economic reality test must be applied in each instance to determine if there was a security.[77]Furthermore, Landreth claimed that the Acts should not apply to this sale because the purchasers were not passive investors of the kind that Congress intended the Acts to protect.[78]

---

69. *Id.* at 2302-03. The normal characteristics of stock were described in *Forman, see supra* text accompanying note 58.

70. *Id.* at 2303.

71. *Id.* The Court later addressed Landreth's contention that Dennis and Bolton were not "investors." *See infra* text accompanying notes 86-91.

72. 105 S.Ct. at 2303.

73. *Id.* at 2303. The Court referred to Marine Bank v. Weaver, 455 U.S. 551 (1982) to illustrate this point. In that case, the Court held that a federally-insured certificate of deposit was not a security. *Marine Bank* 455 U.S. at 555. While the definition of "security" is broad, the Court did not believe that Congress intended to provide a broad federal remedy for all fraud, because the statute provides that instruments are not securities if "the context otherwise requires." *Id.* at 556. Furthermore, it is unnecessary to subject issuers of certificates of deposit to liability under the securities laws because holders are already protected under the banking laws. *Id.* at 559.

74. 105 S.Ct. at 2303. In *dicta*, the Court later addresses the inconsistency of exempting certificates of deposit from coverage while refusing to exempt stocks. *See infra* text accompanying notes 92-98.

75. *Id.* at 2303.

76. *Id.* at 2303.

77. *Id.* at 2304.Landreth also relied on Tcherepnin v. Knight, 389 U.S. 332 (1967), as mandating a determination of whether the economic realities of a transaction call for application of the Acts. *Id.* at 2304 n.4. In *Tcherepnin*, the Supreme Court stated "in searching for the meaning and scope of the word 'security' in the [federal securities acts], form should be disregarded for substance and the emphasis should be on economic reality." 389 U.S. at 366 (citing SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946)).

78. 105 S.Ct. at 2304.

The Court agreed that prior Supreme Court cases had "not been entirely clear on the proper method of analysis for determining when an instrument is a 'security'" and cited cases where the Court had looked to the economic substance of a transaction, rather than just to its form, to determine whether the Acts applied.[79] However, the Court disagreed with Landreth's claim that an economic reality test is required in all circumstances, and refused to apply it for two reasons. First, all of the cases cited by Landreth as requiring an economic reality analysis involved "unusual instruments."[80] In those cases, the instruments were not traditional securities. Thus, the instruments could only be subjected to the Acts' coverage if the economic realities indicated that the instruments were actually securities.[81] Therefore, the economic reality test had been used to include non-traditional instruments in the definition of a security, not to exclude traditional instruments from the statutory definition.[82] The Landreth stock, however, was traditional stock and plainly within the statutory definition. Furthermore, the Court previously acknowledged the possibility that in some cases an instrument would be a "security" simply by proving the document to be what it purported to be.[83] Second, the Court designed the economic reality test to determine whether an instrument was an "investment contract," not whether it fit into any other statutory definition of security.[84] If the Court applied an economic reality test to traditional instruments, it would make the Acts' listing of specific instruments in the definitional sections superfluous.[85]

Having disposed of Landreth's claim that an economic reality test is required in all circumstances, the Court turned to his claim that the Acts were intended to protect only passive investors and not privately negotiated transferees of control.[86] Landreth claimed that Dennis and Bolton

79. *Id.* The cases cited were SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) and SEC v. W.J. Howey Co., 328 U.S. 293 (1945).

80. 105 S.Ct. at 2304. These cases were: SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (holding that leasehold interests in land near proposed oil well drilling were securities); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1945) (holding that units of a citrus grove coupled with a cultivating and marketing contract were "investment contracts" and therefore securities); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 858 (1975) (holding that instrument called stock but which bore none of the characteristics normally associated with stock was also not an "investment contract" under an economic reality test).

81. 105 S.Ct. at 2304.

82. *Id.*

83. *Id.* (discussing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943)).

84. 105 S.Ct. at 2305.

85. *Id. See supra* text accompanying note 64. This reasoning parallels the Second Circuit's in Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982):

> If an "economic reality" test were intended, reference to such specific types of instruments, and common variations of them, would have been inappropriate because a substantial portion of each class of instrument would, in fact, not be within the definition. . . . If the "economic reality" test were to be the core of the definition, only general catch-all terms would have been used.

86. 105 S.Ct. at 2305.

were active entrepreneurs who sought to use or consume the business purchased, just like the purchasers in *Forman* who sought to use the apartments represented by shares of stock.[87] Without answering the question of whether Dennis and Bolton were passive investors, or whether that question was even germane, the Court noted that they had no intention of running the sawmill themselves and that Landreth had in fact stayed on to manage the daily affairs of the business.[88] These facts opened Landreth's assertion that Dennis and Bolton were not passive investors to "some question."[89] In any event, the Court specifically disagreed with Landreth's claim that Dennis and Bolton were not passive investors of the kind that Congress intended to protect with the securities acts.[90] Furthermore, the Court asserted that to read the Acts as "cover[ing] only passive investors" would contradict other portions dealing with tender offers, disclosure of transactions by corporate officers and principal stockholders, and the recovery of short-swing profits gained by such persons.[91]

Having disposed of Landreth's claims, the Court turned to the concerns raised by the Ninth Circuit. The Ninth Circuit had rejected the view that the plain meaning of the definition would be sufficient to hold the Landreth

87. *Id.* at 2304.

88. 105 S.Ct. at 2307. This observation directly contradicts that of the 9th Circuit. *See supra* text accompanying footnotes 27-28. *See also* Brief in Opposition at 3, "Upon closing, Dennis and Bolten were the only directors . . . Dennis became president, and other officers . . . were designated by Dennis and Bolten. Undisputed admissions of fact before the trial court established that Landreths retained absolutely no post-closing control over management of the business, and had no ability to determine the outcome of the purchasers' investment." (citations omitted).

89. 105 S.Ct. at 2307.

90. *Id.* at 2305. Justice Stevens, in dissent, believed that Congress did not intend the anti-fraud provisions to apply to every security transaction. 105 S.Ct. at 2312. (Stevens, J., dissenting). Congress was primarily concerned with securities traded in a public market, and the Act's purpose was to protect investors who had no access to inside information and were unable to protect themselves from fraud by obtaining appropriate contractual warranties. *Id.*

91. 105 S.Ct. at 2305 (citing 15 U.S.C. §§ 78n, 78p). 15 U.S.C. § 78n(d), "Tender offer by owner of more than five per centum of class of securities; exceptions," provides:

> (1) It shall be unlawful for any person . . . to make a tender offer for . . . [certain securities] if, after consummation thereof, such person would, directly or indirectly, be the beneficial owner of more than 5 per centum of such class, unless . . . such person has filed with the Commission a statement containing [certain information].

15 U.S.C. § 78p(a), "Filing of statement of all ownership of securities of issuer by owner of more than ten per centum of any class of security," provides:

> Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 781 of this title, or who is a director or an officer of the issuer of such security, shall file . . . a statement with the Commission . . . of the amount of all equity securities of such issuer of which he is the beneficial owner . . . [and monthly supplements in months where ownership changes].

15 U.S.C. § 78p(b), "Profits from purchase and sale of security within six months," provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale

stock covered by the Acts, because it saw "no principled way" to justify treating bonds, notes, and other categories differently.[92] As support, the Ninth Circuit also cited *Forman*[93] for the proposition that it must investigate the "economic reality" of all transactions to determine if they were transactions in securities.[94] According to the Ninth Circuit, the "economic reality" in *Landreth* was a sale of an entire lumber business, effected through the sale of 100% of a corporation's stock, not an investment in a security.[95]

The Supreme Court expressly refused to decide whether coverage of notes or other instruments could be provable by their names or characteristics[96] but pointed out why it thought that stock was distinguishable from other categories. First, stock is the "paradigm" of a security and purchasers expect it to be covered by the Acts.[97] Second, stock is easily identifiable from internal characteristics and more "susceptible" than other instruments to a plain meaning approach.[98]

> and purchase, of any equity security of such issuer . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer. . . .

The Court, however, did not specify how such a reading would contradict the above quoted sections. The Court appears to be blurring the distinction between "protection" of investors with "regulation" of investors.

92. 105 S.Ct. at 2303. *See Landreth*, 731 F.2d 1348, 1353 (9th Cir. 1984). The Ninth Circuit had applied a "risk capital" test to notes to distinguish investment transactions covered by the Acts from routine commercial transactions which were not covered. *Id.* Under this test, a note was a security only if it was a contribution of risk capital subject to the entrepreneurial or managerial efforts of others. *Id.* (citing Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976)). (This test is basically a form of the *Howey* Court's economic reality test, *see supra* text accompanying note 53.)

Other jurisdictions accepting the sale of business doctrine had made similar distinctions. *See, e.g.*, Fredericksen v. Poloway, 637 F.2d 1147, 1150 (7th Cir. 1981) ("[T]he key to defining the scope of the securities laws is whether the transaction is primarily for commercial (i.e., motivated by a desire to use, consume, occupy or develop), or for investment purposes.") (holding that no security was involved when purchaser took control of a corporation through a purchase of assets and stock.).

93. 421 U.S. at 849.

94. *Landreth*, 731 F.2d at 1352. *See also* King v. Winkler, 673 F.2d 342, 345 (11th Cir. 1982) ("Based on the rationale of *Forman*, we reject a literal test and hold that the 'economic realities' test is appropriate to determine whether a transaction involving stock in a corporation is a 'security transaction' or an 'investment contract' governed by the Federal Securities Acts.").

95. 731 F.2d at 1353.

96. 105 S.Ct. at 2306.

97. 105 S.Ct. at 2306. *See also* Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983) for a discussion of how an expectation of protection by the Acts should be a consideration in finding that stock in a sale of business context is a security.

98. *See* text accompanying note 58 for a list of characteristics normally associated with stock.

The Court's analysis does not, however, answer the question of why stock is inherently more easily identifiable than the notes that the *Marine Bank* Court found were not securities. 455 U.S. at 555. The *Landreth* Court admitted that notes "may now be viewed as a relatively broad term that

C. *Policy Considerations in Landreth*

The Court concluded with a discussion of the policy supporting its decision. Acknowledging the absence of legislative history supporting its broad interpretation of the language of the Acts, the Court provided its own policy reasons for that broad interpretation.[99] First, the "sale of business" doctrine rejected by the Court was based on the assumption that control passed to the purchaser.[100] The Court pointed out that ascertaining whether control passed requires a district court to undertake extensive fact finding.[101] Therefore, the district courts would be forced to undertake a detailed factual investigation merely to determine whether it had jurisdiction in the first place.

Second, and more important, determination of actual control involves difficult questions of line drawing.[102] The Court stated that if the sale of business doctrine were applied to this case, it would also inevitably apply to cases where less than 100% of a company's stock was sold.[103] This in

---

encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context," 105 S.Ct. at 2306; yet the Court did not admit that stock could be situated or traded in a "consumer context . . . or in some other investment context." Therefore, the Court established that "context" for a note may be the transactional context, but "context" for a stock must be completely internal to the instrument. The court held only that stock was a category by itself for purposes of the Acts. *Id.*

99. 105 S.Ct. at 2306-07 n.7.

Justice Stevens in dissent believed that any policy consideration should be based solely on the Congressional policy as reflected in the legislative history. 105 S.Ct. at 2313 n. 2. The legislative history regarding the subject was silent; the majority should therefore have presumed that federal legislation was not intended to displace state authority absent a clearly expressed intent to do so. *Id.*

100. *Id.* at 2307.

101. *Id.* The Court noted that in this case the district court "was required to undertake extensive fact-finding, and even requested supplemental facts and memoranda on the issue of control, before it was able to decide the case." *Id.*

102. *Id.* This point had been relied upon by various lower courts that had rejected the doctrine. *See, e.g.*, Daily v. Morgan, 701 F.2d 496, 503 (5th Cir. 1983) ("[A] rule of law cannot be condemned simply because it requires a court to decide on which side of the line a case falls. But given that little will be gained from adopting the new rule, there is something to be said for simplicity and predictability in the law"). *See also* Golden v. Garafalo, 678 F.2d 1139, 1146 (2d Cir. 1982),

> In "economic reality," considerably less than 100%, and often less than 50%, of outstanding shares may be a controlling block which, when sold to a single holder, effectively transfers the power to manage the business. Actual control depends upon number and dispersal of shareholders, whether they be individuals, other businesses or institutional investors, and a variety of other facts which render control a most uncertain test.

103. *Landreth*, 105 S.Ct. at 2307. *See also* Gould v. Ruefenacht, 105 S.Ct. 2308 (1985), a companion case to *Landreth*. In *Gould*, Ruefenacht purchased 50% of the stock in a closely-held corporation for cash and an agreement to participate in management. *Id.* at 2309. Ruefenacht discovered that the business had been misrepresented to him and he filed suit alleging violation of the Acts. *Id.* at 2301. The district court relied on the "sale of business" doctrine and granted summary judgment for the defendants. *Id.* at 2309. On appeal, the Third Circuit reversed, and the Supreme Court granted certiorari. *Id.* The Supreme Court relied on its decision in *Landreth* to affirm the Third Circuit: the instruments purchased were called stock and possessed all of the characteristics usually

turn would make coverage under the Acts depend upon such factors as the percentage of stock transferred, the number of purchasers, and the provisions for voting and veto rights agreed upon by the parties.[104] The Acts' coverage would, therefore, be "unknown and unknowable" at the time of a sale.[105] "These uncertainties attending the applicability of the Acts would hardly be in the best interests of either party to a transaction."[106]

IV. CONCLUSION AND IMPLICATIONS

The *Landreth* holding answers many questions that had been troubling the lower courts. First, the opinion indicates that all stock that bears the normal characteristics of stock is a "security" for the purposes of the federal securities laws. Second, the "context" of the sale, i.e., whether one share or 100% of the shares are sold, is irrelevant. Also, the motivation of the buyer of this stock is irrelevant. The Acts now recognize no difference between a passive investor and an active entrepreneur. After *Landreth,* as long as a transaction is structured around a purchase of "stock," the federal securities laws will apply, with all of their attendant substantive and procedural advantages.[107] Finally, *Landreth* answers *Forman*'s unanswered question: an economic reality test is required for "stock" *only* when that "stock" does not bear the normal characteristics of stock. *Landreth* established that if "stock" is stock, it is a security.

JAMES E. BURKE

associated with common stock. *Id.* The Court also reiterated its policy reasons for rejecting the "sale of business" doctrine: application of the doctrine would depend on whether control has passed to the purchaser, and control is ascertainable only after extended fact finding and litigation in the courts. *Id.* at 2310-11.

104. 105 S.Ct. at 2307.

105. *Id.*

106. *Id.* Justice Stevens disagreed. He would limit the antifraud provisions to publically traded securities or to those cases where an investor would be unable to obtain full information and appropriate warranties before a purchase. 105 S.Ct. at 2313. There would be uncertainty, but that uncertainty is not a strong enough policy consideration to justify the majority's "bright line" rule that expands federal jurisdiction outside the scope of congress' concern. *Id.*

107. Substantively, under Rule 10b-5, 17 C.F.R. § 240.10b-5, reliance is presumed if an omission is material. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972). Under common law fraud actions, however, plaintiffs must prove reliance. *See, e.g.* W. Prosser, Handbook of the Law of Torts, § 108 (5th ed. 1984). Procedurally, the Securities Exchange Act of 1934 provides broad venue provisions and nation wide service of process. 15 U.S.C. § 78aa.