

3-1-1983

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## Recommended Citation

Cass C. Butler, *The Sale-of-Business Doctrine - Golden v. Garafalo*, 1983 BYU L. Rev. 201 (1983).

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## The Sale-of-Business Doctrine—*Golden v. Garafalo*

Since enactment of the Securities Act of 1933 (1933 Act)<sup>1</sup> and the Securities Exchange Act of 1934 (1934 Act),<sup>2</sup> the term *security* has been broadly applied to combat a battery of promotional investment schemes.<sup>3</sup> Recently, however, the Supreme Court has sought to limit the breadth of federal securities law application.<sup>4</sup> Following the Supreme Court's lead, several cir-

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1. 15 U.S.C. §§ 77a-77aa (1976 & Supp. IV 1980).

2. 15 U.S.C. §§ 78a-78kk (1976 & Supp. IV 1980).

3. The Securities Act of 1933 defines a "security" as follows:

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, 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) (1976 & Supp. IV 1980).

The Securities Exchange Act of 1934 gives the following definition of "security":

(a) When used in this chapter, unless the context otherwise requires—

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(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, 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) (1976 & Supp. IV 1980).

At least seven significant Supreme Court decisions have defined "security." *Marine Bank v. Weaver*, 102 S. Ct. 1220 (1982); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

4. See *Marine Bank v. Weaver*, 102 S. Ct. 1220, 1223 (1982); *Chiarella v. United States*, 445 U.S. 222, 234 (1980); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 41-42 (1977);

cuits have read *United Housing Foundation, Inc. v. Forman*<sup>5</sup> as support for exempting from the operation of the 1933 and 1934 Acts private stock transfers which effectuate the sale of an entire business,<sup>6</sup> though the Supreme Court has not expressly approved this "sale-of-business" exemption. The lower courts which have applied this sale-of-business exemption have held that the test for determining whether instruments labeled as stocks are securities for purposes of the Securities Acts turns not on the literal name of the instruments, but on the "economic realities underlying the transaction."<sup>7</sup> However, refusing to follow this trend toward narrowing the scope of the 1933 and 1934 Acts, the Second Circuit recently rejected the sale-of-business doctrine in *Golden v. Garafalo*.<sup>8</sup>

### I. THE *Golden v. Garafalo* CASE

In November of 1980, Arthur and Gladys Golden agreed to purchase Mackey's Inc., a ticket brokerage firm, from its sole shareholder and chief operations officer, Anthony Garafalo.<sup>9</sup> In order to preserve Mackey's nonassignable building lease, the

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*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736-37 (1975). See generally, Bloomenthal, *Introductory Survey*, 11 SEC. L. REV. at xii (1979); Freeman, *A Study In Contrasts: The Warren and Burger Courts' Approach to the Securities Laws*, 88 DICK. L. REV. 183 (1978-79); Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977); Thompson, *The Shrinking Definition of A Security: Why Purchasing All Of A Company's Stock Is Not A Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982).

5. 421 U.S. 837 (1975).

6. See *Sutter v. Groen*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,783 (7th Cir. Aug. 20, 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977). For applicable federal district court opinions see *Reprosystem v. SCM Corp.*, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,207 (S.D.N.Y. June 30, 1981); *Zilker v. Klein*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,992 (N.D. Ill. Apr. 6, 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,943 (N.D. Ill. Feb. 25, 1981); *Dueker v. Turner*, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977). At least one state court has also rendered an opinion on this doctrine. *Tech Resources, Inc. v. Estate of Hubbard*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,677 (Ga. Oct. 29, 1980). See generally, Seldin, *When Stock Is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982).

7. *Frederiksen v. Poloway*, 637 F.2d 1147, 1152 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

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

9. *Id.* at 1140.

transaction was structured as a sale of stock rather than a sale of assets. On December 31, 1980, a contract of sale was signed, by the terms of which Golden, in exchange for all of Garafalo's stock in Mackey's, was obligated to pay a sum equal to the value of the net assets of Mackey's plus \$108,296 payable in two installments.<sup>10</sup> Executed contemporaneously with the sales contract was a consulting agreement whereby Garafalo would provide advisory services to Mackey's. Additionally, the agreement prohibited Garafalo from engaging in the ticket brokerage business for five years.<sup>11</sup>

Soon after the sale, the Goldens discovered that Garafalo had misrepresented Mackey's sales volume.<sup>12</sup> The Goldens brought suit in federal district court seeking rescission of the sales contract and monetary damages. Their assertions against Garafalo included common-law causes of action as well as alleged violations of federal and state securities laws.<sup>13</sup> Garafalo moved to dismiss the complaint under rule 12(b)(1) of the Federal Rules of Civil Procedure claiming that Golden had failed to state a claim upon which relief could be granted, because the stock sold was merely an "indicium of ownership" and not a security within the purview of the 1933 Act.<sup>14</sup>

Granting Garafalo's motion, the district court held that the transaction was, in reality, the sale of an entire business to be operated by the purchaser. Therefore, under the sale-of-business doctrine, the transferred stocks were not to be treated as securities even though the term "stock" is contained in the statutory

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10. *Golden v. Garafalo*, 521 F. Supp. 350, 351 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

11. 678 F.2d at 1147 (Lumbard, J., dissenting). On December 31, 1980, the attorney for Garafalo sent a letter to the attorney for Golden acknowledging that under the agreement "the new owners will have full operational control of the business and may change currently existing practices and policies." *Id.* at 1147-49. Thus, the Goldens acquired "full operational control of the business" upon signing the agreement.

12. Brief for Plaintiff-Appellant at 3, *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982). The Goldens alleged that the operating earnings of Mackey's had dropped by about 50% between August 31, 1980, and December 31, 1980, contrary to Garafalo's representation that there had been no adverse material change in the business or earnings of Mackey's after August 31, 1980. *Id.*

13. 521 F. Supp. at 352. Count one of the complaint alleged violation of section 17(a) of the Securities Act of 1933 and of rule 10b-5 promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934. Counts two through five alleged common-law breach of contract, common-law fraud, common-law breach of restrictive covenant, and violation of a state securities statute.

14. *Id.*

definitions of "security" under the 1933 and 1934 Acts.<sup>15</sup>

Reversing the lower court, the Second Circuit held that the appropriate inquiry for determining whether an instrument is a security is not simply a matter of finding that there has been an "investment of money in a common enterprise with profits to come solely from the efforts of others (generally referred to as the economic realities test)."<sup>16</sup> Rather, the court applied a "two-part seriatim" test. First, it must be determined whether the instrument labeled "stock" is literally a stock for federal securities laws purposes by looking for the characteristics commonly associated with stock. Second, only if the instrument fails to qualify as stock under the first part of the test should the inquiry shift to whether the instrument can be categorized as an "investment contract" under the economic realities test.<sup>17</sup>

The Second Circuit majority found that the Mackey's stock possessed the five characteristics of common stock frequently cited by courts in similar cases: (1) the right to vote, (2) the right to receive dividends, (3) the potential to appreciate in value, (4) the potential to be pledged, and (5) the potential to be transferred.<sup>18</sup> Holding that the Mackey's stock was covered under the literal terms of the 1933 Act, the court concluded that it was unnecessary to advance the inquiry further. The Second Circuit also held that, although Supreme Court precedent is not dispositive regarding whether a stock is a security under the Acts, the cases do contain language stressing that ordinary stocks are to be treated as securities.<sup>19</sup>

Judge Lumbard dissented, substantially agreeing with the lower court's analysis and arguing that the majority's two-step seriatim inquiry was not mandated by judicial precedent. According to Judge Lumbard, the Supreme Court cases do not require such a test for transactions involving instruments labeled "stock."<sup>20</sup>

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15. *Id.* at 352-54.

16. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The test is referred to as the "Howey" or "economic realities" test. The Second Circuit in *Golden* rejected this test as a "universal jurisdictional test" for application of the Acts regardless of the "facial or legal character of the instrument." 678 F.2d at 1144.

17. 678 F.2d at 1144-47.

18. *See, e.g., United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975).

19. 678 F.2d at 1143-44.

20. *Id.* at 1147-50 (Lumbard, J., dissenting).

## II. ANALYSIS

The Second Circuit's rejection of the sale-of-business doctrine not only required a strained reading of judicial precedent, but was also contrary to policy considerations inherent in the application of the doctrine to 100% stock transfers. While the Second Circuit in *Golden* correctly concluded that the Supreme Court cases *Marine Bank v. Weaver*,<sup>21</sup> *United Housing Foundation, Inc. v. Forman*,<sup>22</sup> and *SEC v. W.J. Howey Co.*<sup>23</sup> were not dispositive as to whether a 100% stock transfer should be characterized as a security, it incorrectly stated that these cases stress the treatment of "conventional stocks" as securities regardless of the nature of the underlying transaction.<sup>24</sup> The Second Circuit also misconstrued *Forman* as establishing a two-part *seriatim* test for examining stock transfers. Because the Supreme Court cases are unclear as to the validity of the sale-of-business doctrine, the Second Circuit should have given more weight to significant policy considerations supportive of the doctrine in 100% stock transfers.

## A. Judicial Precedent

In analyzing the judicial interpretation of "security" as defined in the Acts and the validity of the sale-of-business doctrine, the court examined the three Supreme Court cases referred to above.<sup>25</sup>

*Marine Bank v. Weaver* dealt with a plaintiff who pledged a \$50,000 certificate of deposit to Marine Bank for a \$65,000 loan to Columbus Packing Co. In return for the pledge, the plaintiff was to receive fifty percent of Columbus Packing's profits, the use of a barn and a pasture, and veto power over any future borrowing by Columbus Packing. The plaintiff alleged that Marine Bank had agreed to use the \$65,000 as working capital for Columbus Packing, but instead applied the loan proceeds to a prior delinquent obligation of Columbus Packing.<sup>26</sup>

Disallowing the plaintiff's 10(b)(5) claim against Marine Bank, the Supreme Court stated that "holders of bank certifi-

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21. 102 S. Ct. 1220 (1982).

22. 421 U.S. 837 (1975).

23. 328 U.S. 293 (1946).

24. 678 F.2d at 1143.

25. *Id.* at 1143-46.

26. 102 S. Ct. at 1222.

cates of deposit are abundantly protected under the federal banking laws" and therefore the certificates should not be considered securities for purposes of the federal securities laws.<sup>27</sup> While the Court did state that the statutory definition of a security "includes ordinary stocks," such terminology must be weighed against the Court's additional statement that an "instrument which seems to fall within the broad sweep of the Act is not to be considered a security *if the context otherwise requires*."<sup>28</sup> The Court also concluded that Congress "did not intend to provide a broad federal remedy for all fraud."<sup>29</sup>

The *Marine Bank* Court applied a version of the economic realities test that has been repeatedly used for determining the security status of "uncommon or unusual instruments" under the federal securities laws. The Court stated that the test is "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."<sup>30</sup> Such "unusual investments," which have constituted securities in earlier cases, (1) "involved offers to a number of potential investors, not a private transaction," (2) "had equivalent value to most persons," and (3) "could have been traded publicly."<sup>31</sup> The Supreme Court reasoned that, apart from the rationale that the Federal Deposit Insurance Corporation (FDIC) provided adequate protection, the certificates of deposit in *Marine Bank* were not securities because the transaction (1) did not involve a prospectus, (2) was not designed to publicly trade the certificates of deposit, and (3) provided for a right uncharacteristic of a security—the power to veto any future loans that Columbus Packing may have requested.<sup>32</sup>

Admittedly, stock is not an uncommon instrument. But if the above analysis is nevertheless applied to the facts in *Golden*, the Mackey's stock would not be a security for purposes of the federal securities laws. The transaction in *Golden* did not involve a prospectus, the stock was not intended to be traded pub-

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27. *Id.* at 1225.

28. *Id.* at 1223-25 (emphasis added).

29. *Id.* at 1223.

30. *Id.* (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352 (1943)).

31. *Id.* at 1225 (citing SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943)).

32. 102 S. Ct. at 1225. The Supreme Court stated, "[e]ach transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole." *Id.* at 1225 n.11.

licly (the stock was not registered for public trading at the time of the transaction), and the transaction included a characteristic not common to securities—a noncompetition agreement.<sup>33</sup>

At least one circuit applying the sale-of-business doctrine to a 100% stock transfer has subsequently held that the *Marine Bank* analysis is “not limited to certificates of deposit issued by the FDIC,” but should also apply to “stock” determinations.<sup>34</sup> Hence, contrary to the Second Circuit’s interpretation of *Marine Bank*, a careful reading of the language suggests that ordinary stocks are not always securities for federal securities laws purposes.

*United Housing Foundation, Inc. v. Forman* presented the United States Supreme Court with the issue of whether instruments referred to as “Riverbay stocks” were securities. Purchases of stock by tenants allowed them to “acquire” an apartment in Riverbay Housing Co-op, a nonprofit housing cooperative.<sup>35</sup> Addressing this issue in a two-part opinion, the Court first determined that the Riverbay stock instruments were not literally “stock” under the 1933 Act because they lacked any of the characteristics commonly associated with stock (i.e., the right to vote and to receive dividends, and the potential of the stock to appreciate in value, to be pledged, and to be transferred).<sup>36</sup>

In the second part of the *Forman* opinion, the Court applied the economic realities test to determine whether the Riverbay stock instruments were “investment contracts” as that term is used in defining a security. The economic realities test, as set forth in *SEC v. W.J. Howey Co.* contains three prongs: does the scheme or transaction involve “[1] an investment of money [2] in a common enterprise [3] with profits to come solely from the efforts of others.”<sup>37</sup> The *Forman* Court held that the Riverbay stock instruments were nothing more than security deposits in the Riverbay Housing Co-op and that, as such, they failed the second and third prongs of the economic realities test. Therefore, the instruments were not considered securities under the

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33. 678 F.2d at 1147 (Lumbard, J., dissenting).

34. *Sutter v. Groen*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,783 (7th Cir. Aug. 20, 1982).

35. 421 U.S. at 840-42.

36. *Id.* at 848-51.

37. 328 U.S. at 301.

1933 Act even though they were labeled "stock."<sup>38</sup>

Prior to *Forman*, failure to meet one or more of the three prongs of the economic realities test had never been recognized by the Supreme Court as a basis for holding that an instrument was not a security if the instrument was labeled as one of the specific terms listed in either the 1933 or 1934 Act.<sup>39</sup> Thus, *Forman* became a catalyst for allowing the Court to place limits on the prior broad interpretations of the language employed in the Acts. The district court in *Golden*<sup>40</sup> cited the following language from *Forman* as authority for extending the application of the economic realities test to instruments labeled "stocks":

We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security.'" In either case, the basic test for distinguishing the transaction from other commercial dealings is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'" This test [the economic realities test], in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.<sup>41</sup>

In rejecting the sale-of-business doctrine, the Second Circuit majority read the *Forman* opinion to mandate a "two-part serial-tim" test to determine whether an instrument is a security.<sup>42</sup> Although some commentators have found substantial merit in a two-part test,<sup>43</sup> a careful reading of *Forman* does not support such a holding. The dissent in *Golden* was correct in stating that nothing in the *Forman* opinion establishes a required two-part

38. 421 U.S. at 856-58.

39. See *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

40. *Golden v. Garafalo*, 521 F. Supp. 350, 354 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

41. 421 U.S. at 852 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)).

42. 678 F.2d at 1144-46.

43. See Rapp, *The Role of Promotional Characteristics in Determining the Existence of a Security*, 9 SEC. REG. L.J. 26 (1981). See also Comment, *The Sale of a Close Corporation Through a Stock Transfer: Covered by the Federal Securities Laws?*, 11 SETON HALL L. REV. 749 (1981); cf. Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567 (1980).

seriatim test; but conversely and equally as important, nothing in the opinion categorically limits the defining of a security to an examination of the underlying economic realities, as was done by the district court in *Golden*.<sup>44</sup>

The majority's espousal of a two-part test is particularly questionable because of the Supreme Court's adoption in *Forman* of a substance-over-form approach that emphasizes economic realities as "the basic principle that has guided all of the Court's decisions . . . 'in searching for the meaning and scope of the word "security" in the Acts.'"<sup>45</sup> Of additional significance is the fact that the *Forman* Court reiterated its earlier dictum that a security "might" be found where a document is, on its face, "a note, a bond, or a share of stock." The *Forman* Court used the word "might" to indicate that "it was not establishing an inflexible rule barring inquiry into the economic realities."<sup>46</sup>

The *Forman* Court concluded that the economic realities test was the general intent of the 1933 and 1934 Acts.

Because 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. Thus, in construing these Acts against the background of their purpose, we are guided by a traditional canon of statutory construction: "[A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."<sup>47</sup>

The Second Circuit's reliance on *Forman* as authority for a two-part test is especially confusing in light of an earlier Second Circuit decision. In *Grenader v. Spitz*,<sup>48</sup> the court was faced with stock instruments which, like the Riverbay stock instruments, lacked any of the five generally recognized stock characteristics.<sup>49</sup> The *Grenader* court held that *Forman* rejected the "literal" test which was defined as follows: "[T]he fact that 'stock' certificates are used in a 'stock' corporation is sufficient in itself to bring transactions in the 'stock' within the literal def-

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44. 521 F. Supp. at 356-57.

45. 421 U.S. at 848 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

46. *Id.* at 850 (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943)).

47. *Id.* at 849 (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)).

48. 537 F.2d 612 (2d Cir.), *cert. denied*, 429 U.S. 1009 (1976).

49. *Id.* at 617.

inition of the Acts.”<sup>50</sup> Furthermore, the *Grenader* court’s refusal to use the literal test on instruments that were very similar to those in *Forman* suggests that, contrary to the later position in *Golden*, the *Forman* opinion had never previously stood for a “two-part seriatim” test in this circuit. It is unclear why the *Golden* majority made no attempt to distinguish *Grenader* from *Forman*.<sup>51</sup>

Because the Riverbay stock instruments in *Forman* were not held to be securities as defined under the federal securities laws, the Supreme Court’s decision is necessarily limited to instruments labeled “stock” but lacking in any of the characteristics commonly associated with stock. Thus, any support that the majority found for applying *Forman* to instruments which are labeled “stock” and which possess one or more of the characteristics commonly associated with stock was grounded only on dicta.<sup>52</sup>

The *Forman* opinion does not dictate that the name of an instrument, in and of itself, is dispositive in defining “security” for purposes of the 1933 Act. However, it does hold that an instrument’s name is a relevant factor if “the use of a traditional name . . . will lead a purchaser justifiably to assume that the federal securities laws apply.”<sup>53</sup> *Forman* emphasized the importance of the name of an instrument in cases in which the “underlying transaction [not the instrument] embodies some of the significant characteristics typically associated with the named instrument.”<sup>54</sup>

Against this backdrop of judicial construction, *Frederiksen v. Poloway*<sup>55</sup> and subsequent cases argue that in a 100% stock

50. *Id.* at 616 (quoting *Forman v. Community Serv., Inc.*, 500 F.2d 1246, 1252 (2d Cir. 1974)).

51. It might be argued that the court in *Grenader* did not apply the literal test (the first part of the “two-part seriatim” test) because the stock instruments involved in *Grenader* lacked those characteristics which the test specifically examines. However, to suggest that the *Grenader* court would have used the literal test if the stocks had possessed one or more of the five characteristics is purely speculative.

52. This is the same argument that the majority used to refute “any language suggesting that the three-pronged economic reality test . . . is the exclusive determinant . . .” 678 F.2d at 1144.

53. 421 U.S. at 850.

54. *Id.* at 851.

55. 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981). While the sale-of-business doctrine first appeared in *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977), the reasoning in *Frederiksen* is more frequently relied upon in support of the doctrine.

transfer the intent is to transfer a business in which stock is merely an indicium of ownership. Unlike typical investors, purchasers of 100% of the stock are essentially buying the assets of the business. Sale-of-business doctrine proponents reason that because the sale of assets is not covered under the Acts, neither should 100% stock sales be covered.<sup>56</sup> Furthermore, the purchaser can vote all of the stock as he wishes, declare dividends at will, and control other aspects of the business typically managed by sole owners. Accordingly, the intent of the Act to cover passive investors is not furthered by extending coverage to those who manage the businesses in which they have invested.<sup>57</sup>

In light of the above arguments for and against the sale-of-business doctrine, it is clear that reliance on *Forman* for support or rejection of the sale-of-business doctrine will continue to result in a standoff, each side quoting passages that tend to strengthen its interpretation and down playing those passages which tend to weaken its position.<sup>58</sup> Perhaps the unclear Supreme Court precedent explains the current split of authority among the circuits.<sup>59</sup> Obviously the confusion regarding interpretation will continue until the Supreme Court or Congress clarifies this issue. Pending such clarification, the acceptance or re-

56. See *Sutter v. Groen*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,783 (7th Cir. Aug. 20, 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977); *Reprosystem v. SCM Corp.*, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,207 (S.D.N.Y. June 30, 1981); *Zilker v. Klein*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,992 (N.D. Ill. Apr. 6, 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,943 (N.D. Ill. Feb. 25, 1981); *Dueker v. Turner*, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977).

57. This intent was expressed by President Franklin D. Roosevelt in his proposal to the Senate for federal regulation of securities when he said, "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." Message from the President—Regulation of Security Issues, 77 CONG. REC. 937 (1933).

58. See generally *Seldin*, *supra* note 6.

59. Four circuits have rejected the sale-of-business doctrine. See *Cole v. PPG Indus., Inc.*, 680 F.2d 549 (8th Cir. 1982); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Glick v. Campagna*, 613 F.2d 31 (3d Cir. 1979); *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). Three circuits accept the doctrine: *Sutter v. Groen*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,783 (7th Cir. Aug. 20, 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977).

jection of the doctrine should involve a weighing of policy considerations.

### *B. Policy Considerations*

The Second Circuit in *Golden*, and other circuits in sale-of-business cases, have been presented with a variety of policy considerations both supporting and opposing the doctrine.<sup>60</sup> Addressing all such considerations is beyond the scope of this note. However, three significant policy considerations support application of the doctrine to 100% stock transfers: (1) the congressional intent underlying the Acts is consistent with the doctrine, (2) application of the economic realities test to several of the definitional terms, other than investment contracts, listed in the Securities Acts supports applying the test to stock transfers as well, and (3) application of the doctrine to 100% stock transfers should not be prohibited because of "unclear contours" that arise with the application of the doctrine to stock transfers of less than 100%.

#### *1. Congressional intent*

In rejecting the sale-of-business doctrine, the court in *Golden* held that Congress, when drafting the 1933 and 1934 Acts, devised a definition of "security" which is confusion free, one that courts can mechanically apply to avoid the "slippery legal and factual issues going to jurisdiction."<sup>61</sup> The court stated that Congress "may have had good reason to draft the definition of 'security' so as to include all instruments having commonly agreed upon characteristics such as 'stock,' leaving 'economic reality' to govern only the catch-all phrase 'investment contract' in cases involving unusual or unique instruments."<sup>62</sup> However, it is illogical to argue that Congress intended to limit application of the economic realities test to investment contracts. Congress did not formulate the test; it was judicially created. Furthermore, if Congress intended that *all* instruments labeled "stock" be defined as securities for purposes of the federal securities laws, why then were the definitions of security in both the 1933 and 1934 Acts prefaced with the words, "unless the context other-

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60. See generally Thompson, *supra* note 4, and Seldin, *supra* note 6.

61. 678 F.2d at 1146.

62. *Id.*

wise requires"?<sup>63</sup>

## 2. Uniformity

Even though the economic realities test developed in the context of the general catch-all term "investment contract,"<sup>64</sup> there is no reason that it should not also be applied to the more specific terms of the definitional sections of the Acts. If the economic realities test accurately furthers the intent of the Acts to afford investors fraud protection,<sup>65</sup> then arguably the test should be controlling even though the instrument falls within one of the literal terms of the Acts.

*Frederiksen v. Poloway* and other cases applying the sale-of-business doctrine have followed this line of reasoning. They have generally viewed Supreme Court precedent as inconclusive on the issue of whether an instrument labeled as "stock" is a security; rather, they have characterized the sale-of-business doctrine as merely a specific application of a more general analysis appearing in a large body of case law.<sup>66</sup> In this body of law, one or more of three versions<sup>67</sup> of the economic realities test have been used to determine federal securities laws coverage of (1) promissory notes,<sup>68</sup> (2) bank lines of credit,<sup>69</sup> (3) certificates of deposit,<sup>70</sup> (4) loan participation interests,<sup>71</sup> and (5) franchise

63. 15 U.S.C. § 77b(1) (1976 & Supp. IV 1980); 15 U.S.C. § 78c(a)(10) (1976 & Supp. IV 1980).

64. See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

65. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In analyzing the intent of the 1933 Act, the Court stated that the 1933 Act was "to protect investors against fraud." *Id.* at 195.

66. See Seldin, *supra* note 6, at 639.

67. The three versions are: (1) The "commercial-investment dichotomy" test. *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974) (bank note was not covered under the Acts where the note was issued in the context of commercial paper rather than investment paper). (2) The "risk capital" test. *United Cal. Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977) (analysis of note included six factors: (a) duration of the note, (b) nature of the collateralization, (c) form of the obligation, (d) circumstances of issuance, (e) relationship between amount borrowed and the size of the borrower's business, and (f) the contemplated use of the funds). (3) The "literal" or "family resemblance" test. *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) (note was not covered under the Acts where the note had a maturity exceeding nine months and did not have a strong resemblance to the types of notes not literally covered by the Acts). See Seldin, *supra* note 6, at 639 n.7.

68. *United Am. Bank v. Gunter*, 620 F.2d 1108 (5th Cir. 1980).

69. *Great W. Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

70. *Canadian Imperial Bank of Commerce Trust Co. v. Fingland*, 615 F.2d 465 (7th Cir. 1980).

71. *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d

interests.<sup>72</sup>

### 3. 100% versus less-than-100% stock transfers

At least one commentator has reasoned that there is theoretically no reason to prohibit application of the sale-of-business doctrine to majority stock transfers of less than 100% once sanction has been given to 100% stock transfers.<sup>73</sup> The Second Circuit in *Golden* was justifiably concerned with the "unclear contours" of the sale-of-business doctrine result if the economic realities test were in fact used to exempt transactions in which less-than-100% stock ownership is transferred. Some of the untested and therefore "unclear" transactions contemplated include: (1) purchasers who delegate management to third parties but maintain control of the business, (2) purchasers who buy from passive investors who have displayed little or no involvement in management of the business, and (3) purchasers who jointly manage with third parties possessing no ownership interest in the business.<sup>74</sup>

It is apparent that in such transactions it would be difficult to determine if sufficient control was left in the hands of the seller or another to qualify under the third prong of the economic realities test (profits to come through the efforts of others) and thereby pull the transaction within the provisions of the federal securities laws. Several commentators have suggested that these difficulties may be alleviated only by limiting the doctrine to 100% stock transfers.<sup>75</sup> The authorities cited by the dissent in *Golden* serve as a pragmatic reminder that the doctrine has been thus limited in the past and that most of the courts applying the sale-of-business doctrine have not extended application to less-than-100% stock transfers.<sup>76</sup>

There exists an important difference between 100% and less-than-100% stock transfers which makes judicial line-drawing more acceptable. Had Garafalo wished to sell one-half of the assets in Mackey's but keep 100% ownership in the remaining

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1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

72. *Martin v. T.V. Tempo, Inc.*, 628 F.2d 887 (5th Cir. 1980).

73. See Seldin, *supra* note 6.

74. 678 F.2d at 1141-42.

75. See generally Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99 (1982); Comment, *The Sale of a Close Corporation Through a Stock Transfer: Covered by the Federal Securities Laws?*, 11 SETON HALL L. REV. 749 (1981).

76. 678 F.2d at 1148-50 (Lumbard, J., dissenting).

assets, could he have done so, by selling one-half of his stock? A shareholder who sells fifty percent of the outstanding stock is not selling the corporate assets; he is merely selling his interest in the corporation which is the fictional owner of the assets. It is apparent that only by transferring 100% of the outstanding stock can the entire interest in a given asset also be transferred.<sup>77</sup>

The majority should have applied the above policy considerations to the facts in *Golden* and exempted the transaction from federal securities law coverage. Excluding the transaction from federal securities law coverage would not have left the plaintiff without a remedy, since the transaction was adequately protected by both the common law and the blue-sky laws of the state of New York.<sup>78</sup>

### III. CONCLUSION

Although *Golden v. Garafalo*<sup>79</sup> presented the Second Circuit with ideal facts for the application of the sale-of-business doctrine, the court rejected the doctrine. This Case Note has shown that not only was the Second Circuit's interpretation of *Forman* and other judicial precedent legal legerdemain, but that policy considerations tend to support applying the doctrine to 100% stock transfers. The United States Supreme Court or the Congress should remove further confusion by specifically creating an exception to the 1933 and 1934 Acts for sales of privately held businesses accomplished through a stock transfer. Until such

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77. However, a problem with restricting the sale-of-business doctrine application to 100% stock transfers is the lack of a conceptual difference between a purchaser who owns no stock before the sale and an inside purchaser who owns a majority of the stock. While both purchasers eventually acquire 100% of the outstanding stock, the inside purchaser has the right to inspect the corporate records and control management prior to the sale. To preclude application of the sale-of-business doctrine to the inside purchaser would allow more protection to the inside purchaser than would be available to the purchaser who owns no stock before the sale. The inside purchaser would have not only the protection of the federal securities laws but also the control of the corporation and the right to inspect its records.

The only judicial solution which will correct this discrimination is to allow the application of the sale-of-business doctrine to not only 100% stock transfers but also to majority inside purchasers who buy up the remaining shares.

78. 678 F.2d 1149 (Lumbard, J., dissenting). Significantly, the Goldens were able to "inspect the business before they bought it; they obtained specific warranties and representations regarding the business's tangible and intangible assets; and they obtained 'full operational control of the business' from the moment they signed the purchase agreement." *Id.*

79. 678 F.2d 1142 (2d Cir. 1982).

time, a split in authority will continue among the circuits: the Second, Third,<sup>80</sup> Fourth,<sup>81</sup> and Eighth<sup>82</sup> Circuits having rejected the sale-of-business doctrine, and the Seventh,<sup>83</sup> Tenth,<sup>84</sup> and Eleventh<sup>85</sup> Circuits having accepted it.

*Cass C. Butler*

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

81. *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

82. *Cole v. PPG Indus., Inc.*, 680 F.2d 549 (8th Cir. 1982).

83. *Sutter v. Groen*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,783 (7th Cir. Aug. 20, 1982).

84. *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. Apr. 19, 1977).

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