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THE SALE OF BUSINESS DOCTRINE: A TRANSACTIONAL APPROACH FOR DETERMINING THE COVERAGE OF THE FEDERAL SECURITIES LAWS

*Golden v. Garafalo*¹

A business may be sold by transferring stock or by transferring assets. Parties may prefer a stock sale for a variety of reasons, such as securing more favorable tax treatment² or maintaining nonassignable leasehold rights.³ The disadvantage of a stock sale is that the seller must comply with the registration and anti-fraud provisions of the federal securities laws.⁴

This disadvantage may be reduced, however, by defining "security" through a transactional approach. Some courts apply the sale of business doctrine⁵ when the primary purpose of a stock sale is the transfer of owner-

1. 678 F.2d 1139 (2d Cir. 1982).

2. Corporate stock is a capital asset, I.R.C. § 1221 (1976), and a gain on its sale qualifies for capital gain treatment. *Id.* § 1201. If a transaction is structured as a sale of assets, inventory would not be a capital asset under § 1221, and gain on sale would be ordinary income. *Id.* § 61(a)(3). Gain on the sale of depreciable business assets would also be recaptured as ordinary income. *See id.* §§ 1231, 1245, 1250.

3. *See Golden*, 678 F.2d at 1140.

4. The federal securities laws referred to in this Note are the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1976 & Supp. IV 1980), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. IV 1980). Under these laws, non-exempt security transactions must be registered. The exemption most frequently applied to sale of business transactions is the private placement exemption for affiliates and controlling persons, which requires satisfaction of the many conditions under § 4(1) and § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(1), (2) (1976). *See generally Vaughn, The Section "4(1½)" Phenomenon: Private Resales of "Restricted" Securities*, 34 BUS. LAW. 1961 (1979). All securities transactions, whether or not exempt from registration, are subject to the Act's anti-fraud provisions. *See Securities Exchange Act of 1934*, § 10b, 15 U.S.C. § 78j(b) (1976).

5. *See, e.g., Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Frederickson 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, at 96,053 (10th Cir. April 19, 1977); *Seagrove Corp. v. Vista Resources, Inc.*,

ship from one who has managed the business to a purchaser-operator.⁶ These courts label this transaction as a sale of a business and do not apply federal securities laws. They emphasize the economic realities underlying the transaction rather than the name of the instrument effecting the transfer. Other courts, however, refuse to recognize the doctrine.⁷

In *Golden v. Garafalo*,⁸ the United States Court of Appeals for the Second Circuit declined to recognize the doctrine. The Goldenes purchased all of the stock in a business that they intended to manage personally.⁹ They sued Garafalo under the federal securities laws, alleging that he misrepresented the value of the stock. The United States District Court for the Southern District of New York applied the sale of business doctrine and found that federal securities laws did not apply.¹⁰ In reversing the lower court, the court of appeals found that United States Supreme Court precedent and congressional intent did not support the doctrine.¹¹ The court also stated that practicality and policy concerns supported rejection of the doctrine.¹²

The court of appeals first analyzed the Supreme Court's decision in *United Housing Foundation v. Forman*.¹³ In *Forman*, a stock purchase served as a recoverable deposit on an apartment. To obtain an apartment, a tenant was required to purchase a fixed number of shares, transferable at a specified price only to new apartment occupants or the housing cooperative.¹⁴ These shares lacked the most important characteristics of corporate stock:

534 F. Supp. 378 (S.D.N.Y. 1982); *Somogyi v. Butler*, 518 F. Supp. 970 (D.N.J. 1981); *Oakhill Cemetery, Inc. v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981); *Anchor-Darling Indus. v. Suozzo*, 510 F. Supp. 659 (E.D. Pa. 1981); *Barsy v. Verin*, 508 F. Supp. 952 (N.D. Ill. 1981); *Dueker v. Turner*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386, at 97,535 (N.D. Ga. Dec. 28, 1979); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964, at 96,051 (D. Colo. May 13, 1977).

6. The doctrine has been applied regardless of the business size. *See, e.g.*, *Reprosystem, B.V. v. SCM Corp.*, 522 F. Supp. 1257, 1273-74 (S.D.N.Y. 1981) (complex transaction valued in excess of \$10,000,000).

7. *See, e.g.*, *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin v. Polish-ing Mach. Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *Mifflin Energy Sources, Inc. v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976).

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

9. *Id.* at 1140.

10. *Golden v. Garafalo*, 521 F. Supp. 350, 358 (S.D.N.Y. 1981), *rev'd*, 678 F.2d 1139 (2d Cir. 1982).

11. 678 F.2d at 1143-44.

12. *Id.* at 1142, 1145-46.

13. 421 U.S. 837 (1975).

14. *Id.* at 842-43. The tenants did not hold legal title to their apartments, but the stock entitled them to occupancy rights. *Id.* at 842 n.4. Although it is not clear why the term "stock" was used, it is often used as a matter of tradition and conven-

appreciation in value and payment of dividends.¹⁵ Therefore, the Supreme Court found that federal securities laws did not apply.¹⁶

The court of appeals in *Golden* interpreted *Forman* as requiring a two-part seriatim test, which first determined whether the instrument constituted ordinary stock.¹⁷ If the instrument was not ordinary stock, only then did the analysis question whether the transaction was a security transaction in economic reality. The court concluded that the instrument was ordinary stock, and therefore held that the transactional approach did not apply.¹⁸ The dissenting opinion in *Golden*, however, stated that nothing in *Forman* suggested or required this bifurcated approach.¹⁹

The confusion stemmed from *Forman's* two-part structure. The Supreme Court structured the opinion to correspond to the lower court's two-part decision.²⁰ The court of appeals held on two alternate grounds that the sale of the housing cooperative stock was a security transaction.²¹ First, the court found that the sale was a security transaction because federal securities laws specifically define security to include stock.²² Second, the court held that the transaction was in economic reality a securities

ience. See P. ROHAN & M. RUSKIN, *COOPERATIVE HOUSING LAW & PRACTICE* § 2.01(4) (1973).

15. See *Sutter v. Groen*, 687 F.2d 197, 200 (7th Cir. 1982); *Golden v. Garafalo*, 678 F.2d at 1143.

16. 421 U.S. at 859-60.

17. 678 F.2d at 1144. 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, 757-58 (1981).

18. 678 F.2d at 1144.

19. *Id.* at 1148 (Lumbard, J., dissenting).

20. *Id.* The Court indicated that it was responding to the Second Circuit's alternate holding. 421 U.S. at 851.

21. *Forman v. Community Serv., Inc.*, 500 F.2d 1246, 1250-57 (2d Cir. 1974), *rev'd*, 421 U.S. 837 (1975).

22. 500 F.2d at 1252-53. "Security" is defined in § 3(a)10 of the Securities Exchange Act of 1934.

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). The definition of "security" in the Securities Act of 1933 is similar. See 15 U.S.C. § 77b(1) (1976).

transaction.²³

The Supreme Court rejected both arguments. First, the Court found that the name of an instrument is not dispositive.²⁴ The Court stated that Congress intended federal securities laws to apply when the economic realities of a transaction so indicated, rather than when the name of the instrument seemingly dictated.²⁵ The Court also was guided by the principle that form should be disregarded in favor of economic substance.²⁶ Despite this discussion in *Forman*, the court of appeals in *Golden* stated that the Supreme Court did not consider the economic realities of the transaction.²⁷

At the beginning of the second part of the *Forman* opinion, the Supreme Court reexamined economic realities.²⁸ The Court rejected the court of appeals' alternate holding that the sale was a security transaction in economic reality.²⁹ The issue was whether the tenants purchased the stock with an expectation of profit. Although the court of appeals realized that there was no profit possible on a resale, it found an expectation of profit in the form of tax benefits and below-market rental costs.³⁰ The Supreme Court found that profit was possible, but not expected.³¹ Because there was no expectation of profit, the Court held the sale was not a security transaction in economic reality.³²

Forman did not specifically hold that economic reality is necessary to determine the security status of conventional corporate stock because the

23. *Forman v. Community Serv., Inc.*, 500 F.2d at 1255. The Second Circuit stated that an instrument is a security in economic reality when a person invests in a common enterprise with an expectation of profits derived solely from the efforts of a promoter or a third party. *Id.* at 1253-54 (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)). The Second Circuit found an expectation of profits from tax benefits and a rental charge below the market rate. *Id.* at 1254. Other elements of the economic realities test were not discussed. *See id.* at 1254-55.

24. 421 U.S. at 848.

25. *Id.* at 849. To avoid the conclusion that any stock is a security, the Supreme Court reasoned that an instrument might be within the letter of the statute, yet not within the scope that Congress intended. *Id.* (citing *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892)).

26. 421 U.S. at 848.

27. 678 F.2d at 1144.

28. 421 U.S. at 851.

29. *Id.* at 858.

30. *Forman v. Community Serv., Inc.*, 500 F.2d at 1254. The tax benefit was a deduction for the pro rata share of the cooperative's mortgage interest payments. The lower rental rate was partially due to the location of commercial enterprises on the premises. *Id.*

31. 421 U.S. at 858. Commercial rental income offsetting rental costs was not mentioned in the cooperative's information bulletin. The commercial enterprises were established to provide residents with essential services, not to make a profit. *Id.* at 857.

32. *Id.* at 858. The court noted that purchasing a commodity for personal use is not a securities transaction.

case did not involve conventional corporate stock.³³ This does not substantiate the *Golden* court's contention that the Supreme Court rejected the sale of business doctrine. *Forman* supports a uniform transactional approach.³⁴ The Supreme Court indicated that a securities transaction must involve: (1) an investment in a common venture, (2) a reasonable expectation of profits, and (3) income derived from the entrepreneurial or managerial efforts of others.³⁵

In *Marine Bank v. Weaver*,³⁶ the Supreme Court provided additional support for the sale of business doctrine. *Marine Bank* involved a six year certificate of deposit—a note.³⁷ Notes, like stocks, are specifically included in the definition of a security in the federal securities laws.³⁸ Nevertheless, the Supreme Court held that the certificate was not within the scope of the federal securities laws; it was unnecessary to subject issuers of bank certificates to securities laws because deposit holders already were protected by federal banking laws.³⁹

Marine Bank implied that Congress did not intend for federal securities laws to cover transactions otherwise adequately protected;⁴⁰ nor did Congress intend for securities laws to provide a federal remedy for all fraud.⁴¹ The laws were designed to protect investors rather than entrepreneurs.⁴² The sale of business doctrine follows *Marine Bank's* limits; the sale of a busi-

33. Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637, 665 (1982).

34. *Id.*

35. 421 U.S. at 852. See SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

36. 455 U.S. 551 (1982).

37. *Sutter v. Groen*, 687 F.2d 197, 200 (7th Cir. 1982).

38. See note 22 *supra*.

39. 455 U.S. at 559.

40. *Sutter*, 687 F.2d at 201; 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, 252 (1982).

41. 455 U.S. at 556.

42. *Sutter*, 687 F.2d at 201. See Thompson, *supra* note 40, at 241. The purpose of protecting investment interests rather than entrepreneurial interests was reflected in President Roosevelt's proposal to the Senate for the federal regulation of securities: "[W]hat we seek is a return to the 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." 77 CONG. REC. 937 (1933). The Senate Committee on Banking and Currency described the objectives of the federal securities laws as: (1) to deal with the excessive use of credit for speculation in the capital markets; (2) to curb the unfair practices employed in speculation in the capital markets; and (3) to end the secrecy surrounding the financial condition of corporations that invite the public to purchase their securities. S. REP. NO. 792, 73d Cong., 2d Sess. 5 (1934). The victims of these evils are investors and not entrepreneurs. *Sutter*, 687 F.2d at 201. The Supreme Court has also found that the primary purpose of the federal securities law was to protect investor interests in the capital market. *Forman*, 421 U.S. at 849. No court has determined that Congress

ness to a buyer who intends to manage that business is not a transaction involving investment interest, and it should not fall within the securities laws.

After interpreting *Forman* as rejecting the sale of business doctrine, the court of appeals in *Golden* examined two practical considerations. First, the court cited the problem of distinguishing investment from entrepreneurial interests as a major reason for rejecting the sale of business doctrine.⁴³ For example, purchase of business stock by a buyer who intended to manage the business would not be within the federal securities laws.⁴⁴ On the other hand, a sale to a purchaser who did not intend to manage the business would be a security transaction because the buyer would rely on the managerial efforts of others.⁴⁵ Therefore, application of securities laws under the sale of business doctrine would depend on the buyer's intent.⁴⁶

The court believed that this distinction, based on subjective indicia, was impractical.⁴⁷ This conclusion is not well founded. First, this distinction has proved workable in other areas of the law, like section 7 of the Clayton Act.⁴⁸ Second, objective factors aid in determining whether a particular stock purchase was made for investment or entrepreneurial purposes.⁴⁹ These include the percentage of stock owned and acquired by the purchaser, and the presence of larger blocs of stock held by other shareholders enabling them to exercise control.⁵⁰

Utilization of a legal presumption also supports the distinction. A sale that gives the purchaser more than 50% of the business is presumed to be

established the federal securities laws to protect entrepreneurial interests involved in sale of business transactions. *See* Thompson, *supra* note 40, at 243.

43. 678 F.2d at 1145-46.

44. The requirement that profits be acquired from the entrepreneurial or managerial efforts of others would not be met. *See Forman*, 421 U.S. at 852.

45. *See* Seldin, *supra* note 33, at 661-65.

46. *See id.* at 660.

47. 678 F.2d at 1145-46.

48. 15 U.S.C. § 18 (1976) (exclusion for stock purchased "solely for investment"). *See* *United States v. Tracinda Inv. Corp.*, 477 F. Supp. 1093, 1098-1102 (C.D. Colo. 1979).

49. Thompson, *supra* note 40, at 258.

50. Other objective factors determining the motivation behind a stock purchase include: (1) cumulative voting or director classifications that enable less than a majority of shares to elect members of the board of directors; (2) the percentage of stock that has been able to elect a majority of the directors in the past; (3) the possibility that cumulative voting or director classifications will permit more than one person or group to elect the board of directors and prevent any one group from obtaining a majority and control; (4) the effect of any voting trust or pooling agreement; (5) if control is indicated, whether that control is illusory given the lack of business expertise; (6) if the possibility of control is indicated, whether the investment has been marketed in a manner that emphasizes the managerial or entrepreneurial efforts of others. *Id.*

entrepreneurial.⁵¹ The presumption can be rebutted by showing that the purchaser's primary purpose was investment.⁵² In *Sutter v. Groen*,⁵³ the United States Court of Appeals for the Seventh Circuit adopted such a presumption.

Another practical problem that disturbed the *Golden* court was the inequity in subjecting only some parties to the same transaction to federal securities laws, as *Canfield v. Rapp & Son, Inc.*⁵⁴ illustrates. In *Canfield*, 75% of the business stock was owned by Canfield, 20% by Neary, and 5% by Weber. All of the stock was sold to Rapp. The court found that, in economic reality, the transaction was intended to transfer the ownership of a business to one who would manage it, and Rapp's federal securities law claim was dismissed.⁵⁵ This logic would not necessarily apply to a suit by the minority shareholders against Rapp or Canfield, for the plaintiff's primary purpose would not be to acquire or divest control of the business.⁵⁶ Rather, the passive minority shareholder would sell to maximize his investment.⁵⁷ Therefore, the sale would be a security transaction in economic reality.

Although this definition prompted the court to reject the sale of business doctrine,⁵⁸ another court and some legal scholars have been willing to apply this definition under facts similar to *Canfield*.⁵⁹ The definition may

51. *Sutter v. Groen*, 687 F.2d 197, 203 (7th Cir. 1982).

52. *Id.* The presumption operates at this point for two reasons. First, such a purchase means effective control. The majority shareholder can control most corporate decisions through its directors. Second, the sale of control usually involves a premium share price. A buyer who does not want control probably would not pay the control premium. *Id.*

53. 687 F.2d 197 (7th Cir. 1982).

54. 654 F.2d 459 (7th Cir. 1981).

55. *Id.* at 468.

56. *See Seldin, supra* note 33, at 680; Thompson, *supra* note 40, at 261. The passive minority shareholder has an interest in an enterprise controlled by another; he is an investor rather than an entrepreneur. *Id.* *See McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 467-68 n.5 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

57. *Seldin, supra* note 33, at 680.

58. 678 F.2d at 1141-42. The court was disturbed with the result obtained when the sale of business doctrine was applied to a transaction involving the purchase of all shares of a business from a number of persons, including passive investors. The protection of the federal securities laws would extend to the passive investors who sold the stock, but not to the new manager. *Id.* In *Oakhill Cemetery v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981), the court concluded that the determination of a security must be mutual; it would not be proper to find that stock is a security for one party but not for other parties to the transaction. *Id.* at 889. Because the plaintiff's claim was dismissed for lack of standing, these remarks are dicta. *Seldin, supra* note 33, at 658.

59. *See McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 467-68 n.5 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981); *Seldin, supra* note 33, at 679-81; Thompson, *supra* note 40, at 261.

produce anomalous results, but it reflects the congressional mandate that the securities laws protect investors rather than entrepreneurs.⁶⁰

Finally, the court found that business purchasers need the protection of the securities laws as much as passive investors.⁶¹ Sale of business transactions, however, do not share two factors that render common law protection inadequate for security transactions.⁶² First, the sale of a business is often direct, so the purchaser and seller are in privity.⁶³ Extension of privity through the federal securities laws is needed to protect subsequent investors, but not to protect purchaser-managers. Second, passive investors need more protection because they can not discover defects in purchases as easily or as quickly as business purchasers.⁶⁴ In sale of business transactions, assets pass to the purchaser, who may examine them and discover any defects.⁶⁵ On the other hand, it is much harder for the passive investor to discover defects in instruments. This inability is caused primarily by the purchaser's lack of control over the business issuing the instrument.⁶⁶ An investor does not normally acquire the access to corporate records and assets that the business purchaser obtains. Thus, an investor needs greater protection from federal securities law than the entrepreneur who purchases management control.

The reasons given by the court of appeals in *Golden* for rejecting the sale of business doctrine lack support. The Supreme Court's recent decisions imply a foundation for the doctrine. The mandate in *Forman* is that

60. *Sutter*, 687 F.2d at 202. The Seventh Circuit has also suggested that the sale of business doctrine might reduce the costs of administering the federal securities laws. *See id.* Courts rejecting the doctrine have argued the doctrine would complicate securities law. They contend that courts could no longer apply the laws by examining only the name of an instrument, fostering increased litigation. On the contrary, the doctrine might diminish federal securities claims because only true security transactions would be covered. Savings in administrative costs might occur because the number of cases applying the more complex securities standard would diminish.

61. 678 F.2d at 1146.

62. Theoretically, the common law protected purchasers of securities as well as purchasers of goods. Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 229 (1933). Nevertheless, the federal securities laws were an explicit congressional recognition that common law fraud was inadequate to prevent misrepresentations in securities transactions. 1 L. LOSS, *SECURITIES REGULATION* 22 (2d ed. 1961). Common law fraud is, however, adequate to protect purchasers from misrepresentations in sales of businesses. Thompson, *supra* note 40, at 243.

63. Shulman, *supra* note 62, at 230.

64. *Id.* Investors might also be more susceptible to misrepresentations than entrepreneurs are. By renting capital, the investor places his confidence and trust in the recipient of the capital to act on the investor's behalf. No such trust exists when an entrepreneur purchases a business. *See Forman*, 421 U.S. at 858 (purchase of a commodity for personal use is not a security transaction).

65. Thompson, *supra* note 40, at 243.

66. *Id.*

the courts must evaluate the economic realities of a transaction to determine whether federal securities law applies. *Marine Bank* indicates that the Court is unwilling to cast the federal securities liability net further than Congress intended. Policy considerations also support the sale of business doctrine. Investors need the protection of the federal securities law; entrepreneurs that purchase a business for control or managerial purposes do not. Therefore, rejection of the sale of business doctrine under the facts in *Golden* seems improper. Future decisions should closely analyze Supreme Court precedent and relevant policy considerations before rejecting the doctrine.

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