LANDERETH TIMBER:
THE END OF THE "SALE OF BUSINESS" EXEMPTION
TO THE SECURITIES ACTS?

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INTRODUCTION

Scope of the National Securities Acts.—Even today, a half-century after their passage, judges and commentators are not agreed on the intended scope of the national securities acts.\(^1\) There continue to be differences of opinion as to whether Congress intended the Securities Act of 1933 and the Securities Exchange Act of 1934 to apply to business investments generally, or only to a more limited range of more traditional "securities" transactions.\(^2\) Section 10-b of the 1934 Act, as buttressed by S.E.C. Rule 10-b(5), is especially troublesome, since it could be read as covering a very wide variety of contracting situations.\(^3\)

It is clear that Congress did intend both Acts to be read broadly, and their definitions to be construed liberally, so as to effectuate their regulatory and prophylactic purposes.\(^4\) The purpose was "truth in securities": full disclosure of all material facts.\(^5\) The courts have generally accepted this broad charter, and tried to effectuate the perceived congressional intent to cover all types of passive investment contracts.\(^6\) The S.E.C. has generally been viewed by both media and scholars as one of the better administrative agencies, and the courts have generally deferred to its expertise.\(^7\)

In recent years, however, several more difficult "boundary" problems have arisen.\(^8\) The courts have been forced to re-examine some of the "blank checks" given to the S.E.C. in prior decisions.\(^9\) The inevitable uncertainties involved in boundary redefinition are causing problems for courts, commentators, and participants in the securities markets.
SIGNIFICANCE OF THE ACTS' APPLICATION

Registration.--The major requirement of the 1933 Act is, of course, the registration of new securities issues prior to their being offered to the public.\textsuperscript{10} Statutory and administrative exemptions from the registration requirement are given,\textsuperscript{11} but if none of these apply, the Act's definition of a "security" has been read very broadly.\textsuperscript{12} In addition to the orange groves in the \textit{Howey} case,\textsuperscript{13} foxes,\textsuperscript{14} beavers,\textsuperscript{15} cosmetics,\textsuperscript{16} and tapes\textsuperscript{17} have all been held to be "securities" under the Act.

In addition to possible fines and administrative penalties, a failure to register where required gives the purchasers the right to recover the amount paid for the stock (less any income received), or damages, if the investor no longer owns the stock.\textsuperscript{18} False or misleading information in the registration statement can also produce civil liability for damages caused to investors.\textsuperscript{19}

Anti-Fraud Provisions.--In addition to requiring companies whose stock is being traded on the exchanges to provide similar kinds of information to the S.E.C., the 1934 Act also outlaws fraud in securities transactions.\textsuperscript{20} Fraud as defined by the 1934 Act is quite different, however, from fraud as defined by the common law. Under common law rules, absent special facts (such as the existence of a fiduciary relationship between the parties), there is no duty to make a full disclosure of all known facts.\textsuperscript{21} Mere silence, in other words, is generally not such a misrepresentation as will provide a basis for a claim of fraud.\textsuperscript{22} Under the Securities Acts' policy of truth in securities, however, the failure to disclose a material fact can be a violation.\textsuperscript{23}

The difference in the operation of the two rules can be seen in the Speed case.\textsuperscript{24} Transamerica made a very generous offer to the stockholders of Axton-Fisher Tobacco Company, to buy all their shares of Class A and Class B common
stock. The offering price was well in excess of the market price. While Transamerica's letter invited questions, it did not specifically tell the stockholders that there was plan to liquidate Axton-Fisher, so as to realize the substantial appreciation in the value of its tobacco inventories. After Transamerica had bought control and implemented its liquidation plan, it was sued by several groups of former Axton-Fisher stockholders, who claimed they would not have sold if they had known the whole story. The court held that the non-disclosure of the liquidation plan made Transamerica's offer "misleading" under the Securities Acts, and ordered payment of damages.25 Under common law rules, since there was no misrepresentation, there would be no case of fraud.

Thus, because of these very different rules under national and state law, most disappointed investors want to be able to sue under the national Securities Acts. If the Acts, especially the 1934 Act, apply, the investors have a relatively easy case to prove.26 If the investors have to sue under state common-law rules, they will probably lose many (perhaps most) cases. Since most state courts try to interpret their state's securities acts to conform to interpretations of the national Acts, a final decision of non-applicability of the national Acts will mean that most state statutes would not apply either. Disgruntled investors in such cases would be left to their state common law remedies in tort and contract.

SALE OF A BUSINESS: COVERED OR NOT?

One of the most troublesome situations for defining the Acts' coverage occurs when the controlling interest in a business is sold, by means of a transfer of that business's stock. Is a takeover buyer, who has dealt directly with the former owner of the business and bought the controlling interest from him, a person whom the Acts were designed to protect?
A Typical Fact Situation.—Ivan and his sons owned all the stock of a lumber business which they operated in the State of Washington. They offered their stock for sale through brokers in Washington and elsewhere. Before a buyer was found, the company's sawmill was heavily damaged by fire. Brokers continued to offer the stock for sale. Prospective buyers were told of the damage, and also that the mill would be completely rebuilt and modernized.

Samuel Dennis, a tax attorney in Massachusetts, received a letter offering the stock for sale, and became interested in buying the business. After having an audit and an inspection of the mill performed, Dennis agreed to buy all of the company's stock. Ivan agreed to stay on for some time as a consultant, to help with the daily operations of the mill.

After the acquisition and reorganization of the company were completed, the mill did not live up to expectations. Rebuilding costs exceeded estimates, and new equipment was not compatible with existing equipment. The company sold the mill and went into receivership. It then sued for rescission of the sale of stock and $2,500,000 in damages, alleging violations of the 1933 Act and the 1934 Act. Ivan and his sons moved for summary judgment, on the basis that the transaction was not covered by the Acts, since under the "sale of business" doctrine, no "security" within the meaning of the Acts had been bought and sold.

Conflicting Interpretations.—The U.S. Courts of Appeal reached diametrically opposed results in cases of this kind. The Second, Third, Fourth, Fifth, and Eighth Circuits decided that such transactions were covered by the Acts. 27 Stock was being transferred, and stock was specifically covered by the Acts as a security. 28 Indeed, transfers of stock were the main concern of the Congress which passed the Acts.
The Seventh, Ninth, Tenth, and Eleventh Circuits reached the opposite result. In their view, there is a difference between investors and entrepreneurs. Congress intended to protect the former, but not the latter. The passive investor depends on others for information about the investment, does not usually engage in face-to-face negotiations with the issuer/seller of the security, and has virtually no control over the invested dollars. In contrast, the entrepreneur who buys a business in order to operate it is in a position to bargain out whatever pre-sale inspections or post-sale guarantees he wishes. He is already adequately protected by contract law and tort law; he does not need the additional protections of the Acts. Sales of businesses were not the problem which the Acts were designed to remedy. There was no intent by Congress to intrude on normal commercial transactions, or to supplant state law remedies for fraud and breach of contract.

Economic Realities and Investment Contracts.--Promoters can be very ingenious in devising schemes to separate investors from their money. If the broad remedial purposes of the Acts are to be served, these alternative investment forms must also be covered. The definitions in the Acts must be read with enough flexibility to include arrangements which are clearly intended as investment vehicles.

The main "catchall" phrase in the Acts' definitions is "investment contract." The S.E.C. and the courts have been quite liberal in interpreting this phrase, by focusing on the "economic realities" of the transaction involved. In examining the "economic realities" of the sale of orange groves in Howey, the Supreme Court established the test for defining 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." Using this test, lower
courts have thus applied the Acts to a variety of faunā—the foxes and beavers noted supra,32 chinchillas,33 and even the lowly earthworm.34 Earthworms are "securities" covered by the Acts because the economic reality of the transactions involved indicated an investment of money, in a common enterprise, with the anticipated profits dependent largely if not entirely on the efforts of the promoters of the scheme. Thus, what was involved was not merely the sale of earthworms (or beavers, or whatever), but rather a complex scheme which was in reality an "investment contract"; hence, the Acts applied.

In holding that the Acts applied to the machinations of Glenn Turner and his various companies (cosmetics, motivational tapes, et al.), the Ninth and the Fifth Circuits had modified the Howey test.35 Some minimal, "perfunctory" efforts by the investors did not disqualify the scheme as an investment contract. The key question is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the success or failure of the enterprise."36

Subsequently, in the Forman case, the Supreme Court used the phrase "the entrepreneurial or managerial efforts of others."37

Initially, then, the purpose of the economic realities test was to expand coverage of the Acts. Substance was examined, and allowed to prevail over form. Even though the transaction might be structured as a sale of real or personal property (orange trees, beavers, worms, or tapes), if it was in fact an investment plan, the Acts were applied. The investors in these various schemes were protected, as Congress intended.

Economic Realities and the Contraction of the Acts' Coverage.—An infinitely more difficult question is presented by the reverse scenario. Should the Acts be applied to a contract which is literally within the statutory definition, but which does not seem to be the sort of transaction
with which Congress was concerned? It is one thing to say that the protections given by the Acts can not be avoided by clever draftsmanship, and that the economic realities must prevail over the legal forms used by the parties. Nearly everyone can agree with that salutary result. But should not the reverse also be true? How can the label used by the parties be definitive in one case, but not in the other? Should a simple commercial transaction, which is not an "investment" at all, in any meaningful sense of the word, be subject to the Acts just because it is effectuated by the use of documents which bear the name "stock," or "notes"?

It was on this reverse case that the Circuit Courts parted company. Those courts taking the literal approach said that at least "stock" transfers are covered by the Acts, regardless of the underlying circumstances of the transaction. Even within these literalist Circuits, however, "notes" might be examined with the economic realities test, and partnership contracts definitely would be. There seems to be no disagreement on the difference between a partnership and a limited partnership, as to coverage under the Acts. Since a general partner is in charge of the business, as an equal manager/agent, he is outside the Acts' protections. The purchaser of a limited partnership interest, on the other hand, is protected since he lacks effective control over his investment. It seems somewhat anomalous, therefore, that a similar distinction is not used by these courts when the business is in the form of a corporation, rather than a partnership.

The sale of business doctrine received a tremendous boost from the Supreme Court's decision in United Housing Foundation, Inc. v. Forman. In that case, the Supreme Court decided that "stock" was not always stock for the purposes of the Acts. The "stock" in question had been issued by UHF, a nonprofit membership corporation, as a condition to leasing one of its
cooperative low-income apartments. This "stock" bore "none of the characteristics 'that in our commercial world fall within the ordinary concept of a security'." The shares were not transferable to nontenants, nor could they be pledged or encumbered. They descended only to a surviving spouse. There were provisions for repurchase by UHF if the lease terminated. Each apartment had one vote within the cooperative, regardless of the number of "shares" owned. There was no expectation of profits at all, other than the economic benefits accruing through the lease of the apartment. In sum, the economic reality of this transaction was the leasing of an apartment for personal use, not an investment in a profit-making scheme run by others. Substance prevailed over form.

Similarly, the Supreme Court's 1982 decision in Marine Bank v. Weaver, by reaffirming the use of the economic realities test, seemed to approve courts' examination of the nature of underlying transactions, rather than relying on a more literal reading of the statutory definitions. The Court held that neither the certificate of deposit purchased by the Weavers, nor their business agreement with another family, was a "security" under the Acts. Chief Justice Burger noted that the Acts were not intended as a federal remedy for all types of fraud; that this certificate of deposit was quite different from the withdrawable capital shares of a savings and loan association held to be securities in Tcherepnin v. Knight; and that CDs issued by federally regulated banks were not the same as other long-term debt obligations, since CD buyers are already protected by comprehensive banking regulations. Three years before, the Court had also used this "alternative regulation" argument as one of its reasons for holding that a noncontributory, compulsory pension plan was not a security under the Acts. While this argument has been strongly criticized by at least one commentator, the presence of another
applicable regulatory scheme would certainly seem to be part of the economic realities which the courts should consider in deciding whether a particular transaction is a "security" subject to the Acts.

Thus, in Forman, Daniel, and Marine Bank, the Supreme Court did examine the economic realities of the transactions, and decided in each case that no security was involved.

LANDRETH TIMBER: THREE STEPS FORWARD, ONE STEP BACK?

For some time, the Supreme Court had been dodging a decision on the application of the economic realities test to the sale of business cases, by repeatedly denying certiorari.\(^51\) The Circuits were left to stew in their own split juices. Commentators had a field day, wielding policy arguments and speculating about how (and when) the Court would decide the issue.\(^52\)

Then came Landreth Timber.\(^53\) In a surprising about-face, Justice Powell in effect said, "We didn't really mean it." He accepted a literalist approach where "stock" was involved in the transaction. Forman was distinguished, on the basis that the stock there wasn't really stock, so the economic realities had to be examined. As for Howey, Tcherepnin, Daniel, and Marine Bank, they all involved "unusual" transactions, not clearly covered by the statutory definitions, so the economic realities had to be examined. But as for Landreth Timber, the stock here was really stock, and was therefore "the paradigm of a security."\(^54\) Powell agreed with Professor Loss that the Howey test should not be applied to stock—at least not to stock that was really stock.\(^55\) Powell also recoiled from the idea that the courts would often have to examine the facts to see whether "control" of the business had in fact been passed to the buyer. If less than all of the company's stock was sold, "[t]his inevitably would lead to difficult questions of line-drawing."\(^56\) As a result, "coverage by the Acts would in most cases be unknown and unknowable to
the parties at the time the stock is sold." He thus opted for a simple rule: stock that is really stock is a security, and thus covered by the Acts, regardless of the economic realities of the transaction involved.

POST-LANDRETH: NOW WHAT?

Presumably, when the Supreme Court decides a point of national law, that is that. The split between the Circuits is resolved; all lower national courts are bound by the Supreme Court's interpretation. Unless Congress amends the definitional sections of the Acts, or unless the Court can be persuaded to change its mind, one would have to assume that the "sale of business" exception is no more. Several recent developments, however, indicate that the results are not quite that final. The Court did not fashion a wooden stake from Landreth Timber.

Missing Cases.--U.S. District Courts, along with Circuit Courts of Appeal, are of course bound to follow Supreme Court precedents. That's the way the system works--or is supposed to work. Occasionally, however, a glitch occurs.

Landreth Timber was decided by the Supreme Court on May 28, 1985, and the decision was published in due course, in each of the various reporter series. Nevertheless, when District Judge Suhrheinrich decided Leoni v. Rogers on December 23, 1985, he gave no indication that he was aware of Landreth Timber. He reviewed the statutory definitions, the Forman precedent, and the policy arguments underlying the sale of business exception. He then stated: "The Supreme Court and the Sixth Circuit have never ruled on the issue and the other circuits are split." He did footnote the Ninth Circuit's decision in Landreth, from 1984, with no indication that certiorari had been granted, much less that the Supreme Court had decided the case nearly seven months previously! He then proceeded to apply the sale of business
exception, and to dismiss the case.\textsuperscript{61} It is especially sad that Suhrheinrich missed the Supreme Court's decision, because the \textit{Leoni} facts present the strongest possible argument for use of a sale of business exception. The buyer of the stock had been the manager of the business, and therefore presumably had as much "inside" information about it as anyone could possibly have. He could hardly be said to be the sort of person whom the Acts were designed to protect. It would have been interesting to see if Suhrheinrich could have distinguished \textit{Landreth Timber}.

\textit{Landreth Timber} is the law, in other words, only to the extent that lawyers and judges are aware of it.

\textbf{Ambiguous Opinion}.--Even if made aware of it, judges may still read Powell's \textit{Landreth} opinion differently. He did not specifically state that there is no such doctrine as the sale of business under the Acts. Rather, he said: "We also perceive strong policy reasons for not employing the sale of business doctrine in this case."\textsuperscript{62} Not that there is no such doctrine, but that it should not be applied \textit{in this case}. Again, in concluding, Powell stated: "In sum, we conclude that the stock at issue here is a "security" within the definition of the Acts, and that the sale of business doctrine does not apply."\textsuperscript{63} Here, too, he seems to acknowledge the doctrine's existence; he just didn't want to \textit{apply} it to the case at hand.

Of course, as a practical matter, this seeming ambiguity may not be too significant, since, if the doctrine doesn't apply in this case, it's hard to imagine where it would apply.\textsuperscript{64} Lawyers have been known to make such ingenious arguments, however.

\textbf{Circuit Court Citations}.--\textit{Landreth Timber} has been cited as controlling on the sale of business issue by two Circuit Courts, and referenced in various ways by several others.
In *Wilsmann v. Upjohn Co.*, the Sixth Circuit noted that it had not previously taken a position on the doctrine, and that the other Circuits had been split, but that the Supreme Court had resolved the split in *Landreth*. 65 The District Court had refused to use the doctrine to justify a judgment NOV against a jury verdict for plaintiff Wilsmann. 66 Wilsmann claimed that certain misrepresentations had been made to him to induce him to sell his business to Upjohn. The Circuit Court did, however, vacate the District Court judgment and remand the case, on the basis that the evidence was insufficient to justify the jury's verdict. 67

In *St. Philip Towing and Transp. Co. v. Favers, Inc.*, the Eleventh Circuit, which had adopted the sale of business doctrine in *King v. Winkler*, 68 acknowledged that it had been overruled by the Supreme Court's *Landreth Timber* decision. 69 In a brief, one-page per curiam opinion, the District Court's dismissal of St. Philip's claim was reversed, and the case remanded for further proceedings. 70 The Circuit Court noted that St. Philip's claim was almost exactly the same as that of the buyer in *Landreth*: there had been fraudulent representations about the business, the buyer had purchased all of the stock in the business, and the business had declined sharply shortly thereafter. 71

A Ninth Circuit opinion, *Levin v. Knight*, 72 also contains *Landreth Timber* in a footnote. 73 The issues in *Levin*, however, are whether there was a sufficient memorandum to comply with the Statute of Frauds, and whether a cause of action for fraud had been sufficiently alleged against the buyer. 74 The Ninth Circuit answered both questions in the affirmative, and remanded the case for trial. 75 Judge Barnes, in his dissent, noted that Knight had raised a securities law defense (the sale of business exception), but that the District Court had not considered it, since the Statute of Frauds argument had
been used to dismiss the case. Thus, "On appeal, no federal securities issues have been raised." The Second Circuit also followed Landreth Timber in Schaafsma v. Morin Vermont Corp., although several other issues were also involved in the case.

The Circuit Court held that it had been reversible error to let the jury decide whether the national securities laws applied, since the stock transferred was a security as a matter of law, under Landreth Timber. Only "[n]ovel, uncommon, or irregular devices" raise a question of fact as to the application of the Acts. Plaintiffs were thus entitled to a new trial on their claims under the Acts. As to the claims under Vermont's securities statute, which defines a security in terms of the Howey test, the District Court would have to determine on remand "whether Vermont courts would adopt a different definition today in accordance with current federal law as expressed in Landreth." Where "novel, uncommon, or irregular devices"--or any non-stock transaction--was involved, however, Landreth Timber has not stopped the Circuit Courts from considering the "economic realities" involved in the transaction. Thus, the Third Circuit has held that coal leases were securities. The Seventh Circuit has held that a fact question existed as to whether a limited partnership interest was a security, and the Ninth Circuit, as to oil and gas interests. A real estate joint venture was held not to be a security by the Fifth Circuit. Gold coins were held not to be a security, even when sold on an unusual "prepayment" basis, by the Ninth Circuit. Following the generally accepted interpretation, the Ninth Circuit also held that a partnership interest is not a security. Where shares of stock had been purchased but never issued, the Second Circuit held that they were still securities for the purposes of the Acts.
Presumably, such definitional rulings will continue to be made, in cases involving mechanisms other than stock. As the Seventh Circuit stated in 1986, "There remains a substantial gray area for courts to explore in determining when actual or potential control is sufficient to remove a transaction from the jurisdiction of the federal courts under the securities laws." \( ^{89} \)

**District Court Citations.**—While the Supreme Court's opinion in *Landreth Timber* may have slipped by Judge Suhrheinrich, \( ^{90} \) it has been cited by District Courts in a dozen other securities law cases. \( ^{91} \) In what may prove to be the most significant post-*Landreth* discussion, Judge Kocoras indicated that many corporate reorganizations may still fall outside the Acts. \( ^{92} \) He cited the Penn Central reorganization, where the Third Circuit held that no "sale" or "purchase" had occurred when shareholders in Penn Central swapped for shares in a holding company which owned Penn Central as 100 percent subsidiary. \( ^{93} \) He also quoted a Fifth Circuit decision which stated that a "transfer of securities from a wholly controlled subsidiary to its parent or between two corporations wholly controlled by a third does not amount to a purchase or sale." \( ^{94} \) According to Kocoras, "Under Investment [SIC] Controls Corporation, Penn Central and Rathborne, corporate reorganizations which change only the form of a shareholder's investment are not purchases or sales within the meaning of the securities laws. In such cases the shareholders' ownership interests have not changed." \( ^{95} \) In applying these rules to the facts of the case before him, however, Kocoras found that the securities laws did apply, since there had indeed been a significant change in the nature of the shareholders' interests. Count I of the complaint, which had previously been dismissed under the sale of business doctrine, was reinstated. \( ^{96} \)

Several of the other District Court opinions also involved rulings on motions to dismiss, or on reconsiderations of prior dismissals, under the sale
of business doctrine. The Western District of Tennessee denied a motion to dismiss in Media General, on the authority of Landreth Timber. There was a similar ruling by the Northern District of Illinois in Neuro Corp. The Western District of Washington did reconsider its prior dismissal of a securities law claim, in the light of Landreth Timber, but reaffirmed the dismissal because the alleged misrepresentation "was not reasonably calculated to influence the investing public, and was not part of a scheme to defraud any investor." Securities law claims, which had previously been dismissed, were made part of an order for a new trial granted by the Northern District of Illinois in Libco Corp. That same court also had to sort out a twisted procedural mess in Williams. Two counts of the complaint had alleged securities law violations; one had been dismissed under the sale of business doctrine, and one on other grounds. The defendants had made a second motion to dismiss, which included the count which had previously been dismissed under the sale of business doctrine, even though the plaintiff had not moved for reconsideration of that earlier dismissal. The court held that one dismissal was enough, since the plaintiff had not asked for reconsideration; that RICO claims were not alleged, only a simple business dispute; and that the remaining counts which alleged state law violations should likewise be dismissed.

Recognizing that there was no sale of business exception, the Eastern District of New York still ruled for the defendants on the merits of a securities claim in Wollins. Judge McLaughlin held that there had been no misrepresentation of a material fact, no reasonable reliance by the buyer, and no scienter on the part of the seller.

The main defendant (Arthur Young & Co.) also prevailed in DMI Furniture, Inc. DMI, the buyer of Gillespie Furniture Co., sued the sellers, the CPA
firm which had done Gillespie's books prior to the sale, and Arthur Young & Co., which had been hired by DMI to advise it as to the accuracy of the work done on Gillespie's financial statements by the prior CPA firm. Judge Letts, recognizing the Supreme Court's Landreth Timber opinion, held that DMI's claim was simply one for breach of contract under state law, which did not rise to the status of a violation of 10b of the 1934 Act, and granted Arthur Young's motion to dismiss.106

In non-stock cases, District Courts continued to engage in definitional line-drawing, just as their counterparts were doing in the Circuit Courts. Whether notes were securities under the Acts was held to raise a question of fact, by the Central District of California.107 Notes were held to be securities by the Western District of Arkansas.108 Again following the well-established rule, the Central District of California held that general partnership interests were not securities under the Acts.109

In sum, with the notable exception of one Judge in the Eastern District of Michigan, the District Courts seem well aware of the implications of Landreth Timber. Where stock which is really stock is involved in a securities law claim, motions to dismiss are no longer appropriate, and the case must go to trial on the merits. On the other hand, where non-stock transactions are involved, District Judges still apparently feel free to apply the economic realities test.

State Court Citations.--A LEXIS search for "LANDRETH TIMBER" in the "States" library produced ten state court citations. Two Washington cases involved contract disputes arising out of the Landreth Company's sale of timber.110 A more recent (1981) Washington case, in which the Company was also named as a party, involved conflicting security interests.111 A fourth citation was a denial by the Washington Supreme Court of a petition to review the Court of Appeals decision.112
Only six state cases have thus far cited *Landreth Timber* in the "sale of business" context.\(^{113}\) The Indiana Supreme Court held that there was no sale of business exception in Indiana, although it cited the Ninth Circuit's opinion in *Landreth Timber*, which had upheld the doctrine.\(^{114}\) The South Carolina Supreme Court reached the same result.\(^{115}\) The Minnesota Supreme Court felt compelled to reach the same result, since the State's policy is to coordinate its securities laws with the national ones.\(^{116}\) Justice Kelley said the Court would have used the sale of business doctrine, but for *Landreth Timber*: "Strong legal arguments and sound policy considerations support application of the economic reality or sale of business test in Minnesota, and were we writing on a clean slate, we would do so."\(^{117}\) Kelley quoted Justice Stevens' dissent in *Landreth Timber*: "I do not believe Congress intended the federal securities laws to govern the private sale of a substantial ownership interest in these operating businesses simply because the transactions were structured as sales of stock instead of assets."\(^{118}\) Kelley did not like the results produced in the case at hand, and did not think they were intended by the Minnesota Legislature:

"In this case, we believe application of the act leads to an inequitable result. Although no intent to defraud was ever proven, nor found by the trial court, the total amount of costs, interest, and attorney fees awarded by the trial court under the act approaches punitive damages. In passing, we note that if the Act is applicable under the facts of this case, then it is applicable to all arms-length transfers of closely-held corporations, including incorporated small businesses and family farms. We question whether the legislature intended, or even contemplated, a result that, even in the absence of intent to defraud, would burden in seller with such punitive-like liability damages."\(^{119}\)

Kelley did drastically reduce the "punitive-like" damages—from $442,308.80 to $52,351.06. He affirmed the award of $2555 for costs, but he remanded the trial court's awards of $49,558.22 for interest and $76,476.12 for attorney's
fees. He at least lessened the impact of the rule from Landreth Timber, even if he felt bound to apply it.

The New York courts had occasion to utilize Landreth Timber in a rather different "sale of business" context. John and Salvatore Agosta, brothers, each owned 50 percent of the stock in Fontana D'Oro Foods. When it dispute arose between them, it was settled by an agreement, under the terms of which John would buy Salvatore's stock for $505,000, and Salvatore would sever his connection with the firm. A warehouse which was a major asset of the firm burned down prior to performance of the agreement. John refused to go through with the stock purchase, claiming "impossibility of performance." The Supreme Court (Trial Term) agreed, stating that the contract had been for the sale of an ongoing business, and had been "frustrated" by the destruction of one of the firm's major assets. The Appellate Division reversed, using "risk of loss" rules for real estate and goods, and ordered enforcement of the stock-purchase agreement. The Court of Appeals held that the Appellate Division had reached the right result, but for the wrong reasons. The agreement was for the purchase of stock, not tangible business assets, and there was nothing "impossible" about the transfer of Salvatore's stock. The fact that the parties might have structured their transaction as a sale of tangible assets was irrelevant; they did not do so. The Appellate Division's order for enforcement of the agreement was affirmed.120

However, using a "two-fold analysis" which it felt was consistent with Landreth Timber, the New York Court of Appeals has also held that campsite memberships were not "securities" under the New York securities laws.121 Similarly, the Supreme Court of California has held that the applicability of that State's securities laws to corporate promissory notes is a question of fact, which must be decided by the jury.122 Thus, in these two large and
commercially important States, the highest courts continue to apply a kind of "economic realities" test to non-stock transactions.

CONCLUSIONS

Whatever the inherent merits of the sale of business doctrine, and whatever the "sound policy reasons" for using it, the U.S. Supreme Court decided not to "apply" it in Landreth Timber. Since that decision, both state and national courts have been applying their respective securities laws to sales of businesses accomplished by means of stock transfers. At the same time, however, courts continue to look to the economic realities in non-stock transactions. Resolution of this seeming inconsistency will have to await changes in the Securities Acts themselves; there seems little likelihood that the Supreme Court will reverse its 8 to 1 vote in Landreth Timber.

Sellers of businesses who wish to avoid the impact of the Securities Acts will thus have to structure their transactions as asset sales, rather than stock sales. This seems to be an unwarranted intrusion into the marketplace by the government, and a cumbersome and unnecessary requirement. Why force the parties to organize a new corporation, to sell the assets to it, and to dissolve the old corporation? Why not let the original corporate business continue, if the economic realities underlying the two transactions are the same?

The impact of Landreth Timber seems particularly troublesome in one area: corporate divestitures. If a conglomerate wishes to rid itself of a marginally profitable subsidiary, or is required to divest in an antitrust proceeding, are those transactions also subject to the Securities Acts, if they are structured as stock sales rather than asset sales? Landreth Timber would seem to so indicate. Conglomerates wishing to rationalize their divisions would be well-advised to keep this possibility in mind. While more
share-swapping "reorganizations" may escape coverage, the changes wrought by a divestiture would not. Pending statutory changes, all sellers of businesses need to beware Landreth Timber.
FOOTNOTES:

1. See infra, at notes 27-29 and 52.

2. See, e.g., the Supreme Court's opinion in Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), which held that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, does not violate the 1934 Act or SEC Rule 10b-5. The Second Circuit had held to the contrary. 533 F.2d 1283 (CA2 1976). See also, McNeny, Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion from Federal Securities Regulation, 8 Fla.St.U.L.R. 295 (1980), and works there cited.

3. One very troublesome issue was disposed of the the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), when the Court held that the SEC could not reach merely negligent conduct with Rule 10b-5, since the statutory section on which the rule was based spoke of a "manipulative or deceptive device or contrivance." Clearly, with this language, Congress meant to outlaw only intentional conduct, and not to include mere negligence.

4. "[Congress] defined 'security' very broadly, but presumably to prevent the financial community from evading regulation by inventing new types of financial instruments rather than to prevent the courts from interpreting the Act in light of its purposes." Sutter v. Groen, 687 F.2d 197, 201 (CA7 1982).


6. See infra, at notes 12-17 and 32-37.

7. Wiesen, supra note 5, at page 5: "The SEC is considered by most persons as one of the, if not the, most successful examples of a government operation. Its integrity, usually along with its intelligence and discretion, has almost always been beyond question." See also, Skousen, An Introduction to the SEC, Cincinnati: Southwestern Publishing Co., 1976.

For limits on SEC interpretations, see Medical Committee for Human Rights v. S.E.C., 432 F.2d 659 (DC 1970); Dirks v. S.E.C., 463 U.S. 646 (1983).


10. Securities Act of 1933, sections 5, 6, 7, 8.


22. For an exception case, in which silence was held to be a fraudulent misrepresentation, see Janinda v. Lanning, 390 P.2d 826 (Idaho 1964).


26. As indicated supra at note 23, a mere nondisclosure may be a violation; therefore intent does not have to be proved either, as part of the case. Reliance by the investor is generally presumed. "Materiality" is defined more liberally. Costs and attorney fees are probably awarded more liberally than would be true in many state courts.

27. Golden v. Garofalo, 678 F.2d 1139 (CA2 1982); Seagrave v. Vista Resources, Inc., 696 F.2d 227 (CA2 1982); Ruefemacht v. O'Halloran, 737
F.2d 320 (CA3 1984); Coffin v. Polishing Machines, Inc., 596 F.2d 1202 (CA4 1979); Daily v. Morgan, 701 F.2d 496 (CA5 1983; Cole v. PPG Industries, Inc., 680 F.2d 549 (CA8 1982).


30. Supra note 28.


32. Supra notes 14 and 15.


35. Supra notes 16 and 17.


38. Supra notes 27 and 29.

39. Supra note 27.


42. McAneny, supra note 2, at 311-312.

43. Id.

44. Supra note 37.

45. Id., at 851.
46. 455 U.S. 550.
47. 389 U.S. 332.
54. Id., at 2306.
55. Id., at 2306.
56. Id., at 2307.
57. Id., at 2307.
59. Id., at 533.
60. Id., at 533.
61. Id., at 534.
62. Landreth Timber, supra, at 2306.
63. Id., at 2308.


65. 775 F.2d 713, 719 (CA6 1985).


67. 775 F.2d 713.

68. 673 F.2d 342 (CA11 1982).

69. 768 F.2d 1233 (CA11 1985).

70. Id.

71. Id.

72. 780 F.2d 786 (CA9 1986).

73. Id., at 791.

74. Id., at 787-788.

75. Id., at 788.

76. Id., at 791 footnote 4.

77. Id., at 791 footnote 4.

78. 802 F.2d 629 (CA2 1986).

79. Id., at 637.

80. Id., at 637.

81. Id., at 638.


84. Simon Oil Co., Ltd. v. Norman, 789 F.2d 780 (CA9 1986).


89. Rodeo v. Gillman, supra note 83, at page 93,268.

90. Leoni v. Rogers, supra note 58.


93. In re Penn Central Securities Litigation, 447 F.2d 528 (CA3 1974).

94. Rathborne v. Rathborne, 683 F.2d 914 (CA5 1982).


96. Id.

97. Media General, Inc. v. Tanner, supra note 91.


100. Libco Corp. v. Dusek, supra note 91.


102. Id.

103. Wollins v. Antman, supra note 91.

104. Id.


106. Id.


108. Robertson v. White, supra note 91.


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115. Carver v. Blanford, supra note 64.


117. Id.

118. Id.

119. Id.


121. All Seasons Resorts Inc. v. Abrams, supra note 113.

122. The People v. Figueroa, supra note 113.