

Securities Law: Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Laws. *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

Ulice Payne Jr.

Follow this and additional works at: <http://scholarship.law.marquette.edu/mulr>



Part of the [Law Commons](#)

Repository Citation

Ulice Payne Jr., *Securities Law: Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Laws. Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981), 65 Marq. L. Rev. 487 (1982).
Available at: <http://scholarship.law.marquette.edu/mulr/vol65/iss3/8>

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

tort of bad faith do not lend support for recognizing this new cause of action. The duty to deal fairly and in good faith toward the insured arises from the contract of insurance and is based upon a fiduciary relationship. In an excess judgment case the duty to settle is implied in law to protect the insured from exposure to a judgment in excess of policy limits.¹⁰⁶ It is implied because the insured gives up total control to the insurer and there is an ensuing conflict of interest.

None of the aforementioned principles underlying the recognition of the tort of bad faith could logically be viewed to offer a basis for sanctioning a direct third-party claimant bad faith action against an insurer. Therefore, a clear signal was sent to all interested parties: the Wisconsin Supreme Court will not recognize a cause of action based on a duty to deal fairly and in good faith which runs to and protects third-party claimants.

NANCY J. RICE

SECURITIES LAW — Sale of Business by Transfer of 100% of Corporate Stock Not Governed by Securities Laws. *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

The accelerating momentum of corporate acquisitions has yielded a persistent legal issue which, despite thorough litigation, still lacks final resolution. The question is whether the federal securities laws are controlling when parties execute the sale of an incorporated business by means of a transfer of 100% of the corporate stock. Prior to 1970, it was customary to assume that sale of an existing incorporated business entity via a transfer of stock would fall within the purview of the federal securities laws.¹ However, in subsequent lawsuits de-

106. 23 Cal. 3d at 893, 592 P.2d at 337, 153 Cal. Rptr. at 850 (Richardson, J., dissenting).

1. See, e.g., *Matheson v. Armbrust*, 284 F.2d 670 (9th Cir. 1960), cert. denied, 365 U.S. 870 (1961), where defendant selling 100% of corporate stock contested federal jurisdiction, contending that the federal securities laws exclude private transactions taking place independently of the national exchanges. There was no allegation that stock was not a security.

endants charged with securities violations in the federal courts have argued that the courts did not have "subject matter jurisdiction" for the type of sale transaction in question.² Parties have often insisted that, although the term "stock" is specifically listed within the statutory definitions, corporate stock acquired incident to the purchase of a business is not a "security" within the meaning of either the Securities Act of 1933 ('33 Act)³ or the Securities Exchange Act of 1934 ('34 Act).⁴

The resolution of this jurisdictional issue will impact upon both the judicial forum and the scope of remedies available to the plaintiff. For example, federal rules of procedure are often more advantageous than state rules.⁵ Since courts have liberally construed the antifraud provisions of the '34 Act and

2. The Securities Act of 1933 ('33 Act) provides for concurrent state jurisdiction. 15 U.S.C. § 77r (1976). However, this case analysis is limited to questions involving the jurisdiction of the federal courts. Jurisdiction for lawsuits brought under the '33 Act is provided for by § 22 of the Act. 15 U.S.C. § 77v (1976). If jurisdiction exists over the federal securities claims, then the court may exercise jurisdiction over any pendent state-law causes of action. *See, e.g., Vanderboom v. Sexton*, 422 F.2d 1233, 1241-42 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *Smith v. Manuasa*, 385 F. Supp. 443, 446 (E.D. Ky. 1974).

3. 15 U.S.C. §§ 77a-77aa (1976). The term "security" is defined 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).

4. 15 U.S.C. §§ 78a-78kk (1976). The definition of "security" pursuant to § 78c(a)(10) of this act is similar to the definition stated in the '33 Act. The Supreme Court has treated the two definitions synonymously. *See United Housing Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934). The American Law Institute's consolidated Federal Securities Code does not substantially change the definition of a security. *See FED. SEC. CODE* § 202(150) (1980). For purposes of this analysis, the definitions will be treated as functionally identical.

5. The '34 Act provides for exclusive federal jurisdiction and has broad venue and nationwide service of process provisions. 15 U.S.C. § 78aa (1976). Also, attorneys' fees may be recovered by the successful litigant. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 389-97 (1970).

have required a lesser burden of proof than under common law theories of recovery, the application of federal securities law is often favorable to the plaintiff.⁶

Currently, eleven reported federal cases have considered whether the transfer of stock incident to the sale of a business falls within federal securities laws.⁷ However, prior to *Frederiksen v. Poloway*,⁸ only two appellate courts had addressed this issue, each reaching an opposite result.⁹ In *Frederiksen*, the Seventh Circuit Court of Appeals gave additional support to the position that a security is not involved in such sale transactions. Thus, courts and litigants await the birth of a single, functioning standard for determining whether the sale of a business via the transfer of 100% of the stock is a securities transaction.

I. CASE ANALYSIS

The factual situation in *Frederiksen* involved the sale of a boat marina wherein the purchaser received 100% of the

6. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (reliance on misrepresentations not a prerequisite to recovery); *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978) (improper motive no longer required); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965) (nondisclosure of material information is actionable); *SEC v. Penn Central Co.*, 450 F. Supp. 908 (E.D. Pa. 1978) (proximate causation required).

7. *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 101 S. Ct. 3006 (1981); *Coffin v. Publishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 444 U.S. 868 (1979); *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. April 19, 1977); *Occidental Life Ins. Co. v. Pat Ryan & Assocs.*, 496 F.2d 1255 (4th Cir.), cert. denied, 419 U.S. 1023 (1974); *Ellis v. Henderson*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,722 (W.D. Okla. Oct. 24, 1980); *Mifflin Energy Sources, Inc. v. Brooks*, 501 F. Supp. 334 (W.D. Pa. 1980); *Dueker v. Turner*, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,386 (N.D. Ga. Dec. 28, 1979); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Colo. 1978); *Bula v. Mansfield*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Pa. 1976); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539 (N.D. Ill. 1970).

8. 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981).

9. In *Chandler v. Kew, Inc.*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,666 (10th Cir. April 19, 1977), the Tenth Circuit Court of Appeals affirmed the lower court finding that the sale of a liquor store, with the incidental transfer of stock, was a mere indicia of ownership and did not constitute the sale of a "security." In contrast, the Fourth Circuit Court of Appeals has consistently held that the purchase of a business entity which includes the receipt of 100% of the stock of the company falls within the purview of the federal securities laws as the sale of a "security." *Coffin v. Polishing Machs., Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 444 U.S. 868 (1979); *Occidental Life Ins. Co. v. Pat Ryan & Assocs.*, 496 F.2d 1255 (4th Cir.), cert. denied, 419 U.S. 1023 (1974).

stock of the acquired close corporation.¹⁰ During the months of August through October, 1978, Jeffery E. Frederiksen and Emerald City Corporation (ECC) negotiated for and then purchased the assets and stock of North Shore Marina, Inc. (NSM). NSM was in the business of selling, servicing and providing storage facilities for boats at its location in Waukegan, Illinois. The negotiations produced four separate yet interrelated agreements, which were signed by Mr. Frederiksen, in his capacity as president and *sole shareholder of ECC*, and by Edward Poloway, in his capacity as president and *sole shareholder of NSM*, as well as in his individual capacity.¹¹ The agreement package included a number of provisions,¹² including employment¹³ and management agreements.¹⁴

10. No satisfactory all-purpose definition of a close corporation appears to have ever been devised. However, common characteristics of such corporations are: (1) a small number of stockholders; (2) no ready market for the corporate stock; (3) a substantial majority stockholder participation in the management, direction and operations of the corporation. 1 F. O'NEAL & G. PAYNE, *CLOSE CORPORATIONS* § 1.02 (2d ed. Supp. June 1981).

11. 637 F.2d at 1148.

12. As summarized by the *Frederiksen* court, *id.* at 1149, the package included the following:

1. A purchase agreement, whereby ECC agreed to purchase the assets of NSM at a purchase price of \$191,800 to be paid as follows: \$160,000 was to be paid into an escrow account for use in paying all existing debts of NSM, as well as any unknown liabilities that might arise; the balance of \$31,800 was to be paid in equal monthly installments over a three-year period beginning with the date of closing.

2. A stock purchase and voting trust agreement, which provided that in exchange for \$10 Mr. Poloway would sell 10% of the issued and outstanding stock of NSM to ECC; for an additional \$10 consideration the remaining 90% of the stock would be transferred into a voting trust controlled by Mr. Frederiksen.

3. An employment agreement, wherein ECC would employ Mr. Poloway for a five-year period to "assist, guide and give his expertise" in all areas of ECC's business. *Id.* Mr. Poloway was to perform within the "goals, guidelines, directives, policies and procedures" set forth by ECC in return for an annual salary of \$32,000. *Id.* Additional compensation to Mr. Poloway included a consultant fee and a 20% commission on brokerage sales and the sale of new boats and accessories.

4. A management agreement, which granted ECC authority to operate and manage the marina facilities. ECC was to receive 50% of the gross income derived from the operation of the pavilion at the Waukegan marina. All expenses incurred by ECC in such operations were to be deducted from the remaining 50% of gross income, and the remaining balance was to be paid to NSM.

13. Included in the employment contract was a noncompetition agreement under

ECC terminated its employment agreement with Mr. Poloway approximately seven months subsequent to the signing of the acquisition agreements. Soon after this termination, Mr. Poloway filed suit against ECC and Mr. Frederiksen in the Circuit Court of Lake County, Illinois, alleging breach of contract and fraud.¹⁵

ECC and Mr. Frederiksen, the plaintiffs in the federal action, filed their complaint in the United States District Court for the Northern District of Illinois exactly eleven months following the closing date of the sale transaction. The crux of their complaint was that the interests they acquired in NSM were "securities" within the purview of the federal securities laws, and that in connection with the sale of those interests Mr. Poloway had failed to disclose or had misrepresented certain material facts. In seeking recovery of \$1,250,000 in actual damages and lost profits, the plaintiffs claimed the defendant had violated both the '33 and '34 Acts. The plaintiffs also asserted pendent claims for common law fraud, breach of contract and breach of Illinois securities laws.¹⁶

The defendant moved to dismiss the complaint on the basis of three primary premises: (1) that the federal court lacked subject matter jurisdiction because there was no diversity of citizenship and because the acquisition of NSM did not involve a "security" within the purview of the securities laws, (2) that the plaintiffs' complaint failed to plead the fraud claim with sufficient particularity, and (3) that Mr. Frederiksen was an improper party to the action.¹⁷ The district court granted Mr. Poloway's motion and dismissed the suit. The plaintiffs appealed this ruling.

which Mr. Poloway agreed not to compete within a 75-mile radius of Waukegan for a period of two years following the termination of his employment with ECC. ECC agreed to pay Mr. Poloway \$54,000 for this agreement. (R., Complaint, Exhibit C, ¶ 10).

14. It was understood by the parties that in all probability there would be no remaining income to be paid NSM under the management agreement described *supra* note 11. *Frederiksen*, 637 F.2d at 1149; R., Complaint, Exhibit A, ¶ 16.

15. 637 F.2d at 1149.

16. *Id.* The plaintiffs argued in their brief that the securities laws should be presumed to apply because the allegations in their complaint should be taken as true for purposes of a motion to dismiss. *Id.* at 1150 n.1. The court rejected this argument, stating that the rule cited by the plaintiffs did not apply to conclusions of law and "unwarranted deductions of fact." *Id.*

17. *Id.* at 1149.

A. Purpose of Securities Acts

The Seventh Circuit Court of Appeals began its analysis by examining the purposes and policies behind the securities laws, citing the leading case of *United Housing Foundation, Inc. v. Forman*.¹⁸ In holding that the shares of stock involved were not within the meaning of "securities" under the federal laws, the *Forman* Court asserted that the primary purpose of the '33 and '34 Acts was to eliminate serious abuses in a largely unregulated securities market and "prevent fraud and to protect the interest of investors."¹⁹

This view appears to be consistent with the Acts' legislative histories.²⁰ The emphasis of the federal securities law is on capital transactions rather than those of a commercial nature. After lengthy committee hearings and extensive debate, Congress enacted the federal securities provisions to remedy the practices and abuses which precipitated the stock market crash of October, 1929.²¹ A two-fold policy was implemented. The initial stage represented an attempt to place investors on "equal footing" with respect to investment decisions. This was accomplished by requiring full disclosure of all material information concerning the issuer-seller and the value of the offered security.²² The second segment was an effort to prevent

18. 421 U.S. 837 (1975). Fifty-seven residents of Co-City, a massive cooperative project in New York City, filed an action for fraud under the federal securities laws. The respondents had been required to purchase "stock" in the housing corporation in order to acquire co-op units and alleged that the information bulletin issued at the initial stages of the project misrepresented the co-op's policy regarding absorption by the developers of future cost increases due to such factors as inflation.

19. *Id.* at 849.

20. For a comprehensive history of the '33 and '34 Acts, see J. ELLENBERGER & E. MAHAR, *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934* (1973); see also 1 L. LOSS, *SECURITIES REGULATION* 119-21 (2d ed. 1961).

21. In a message to Congress dated March 29, 1933, President Franklin D. Roosevelt stated: "[T]his proposal . . . puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." 2 *THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT* 93 (S. Rosenman ed. 1938).

22. *SEC v. Galaxy Foods, Inc.*, 417 F. Supp. 1225 (E.D. N.Y.), *aff'd*, 556 F.2d 559 (2d Cir. 1974). See generally James, *The Securities Act of 1933*, 32 *MICH. L. REV.* 624, 624-30 (1934); Landis, *The Legislative History of the Securities Act of 1933*, 28 *GEO. WASH. L. REV.* 29, 30 (1959).

further exploitation of the public by misrepresentation through the sale of fraudulent and worthless securities.²³

B. Scope of Securities Laws

In an attempt to delimit the scope of the federal securities laws, the *Frederiksen* court declared that the key test is "whether the transaction is primarily for commercial (i.e., motivated by a desire to use, consume, occupy or develop), or for investment purposes."²⁴ Citing *Canadian Imperial Bank of Commerce Trust Co. v. Finland*²⁵ and *Emisco Industries, Inc. v. Pro's, Inc.*²⁶ for support, the court elevated substance over form to analyze the underlying economic realities of the transaction.

A careful reading of *Emisco* reveals that the Seventh Circuit determined that the key to the identification of a "security" under the '34 Act is in the commercial/consumer versus investment dichotomy.²⁷ This echoes the ruling of the *Forman* Court, which emphasized that the securities laws do not apply when the goal of the purchaser is not investment but rather "a desire to use or consume the item purchased . . ."²⁸

Although not addressed by the *Frederiksen* court, it should be stressed that the emphasis on placing substance over form for purposes of determining coverage under the federal securities laws must be rigorously tempered by the consideration accorded the reasonable expectations of the investor. The Supreme Court has specified that the criteria to be applied in determining the existence of a security must include:

23. H. R. REP. No. 1383, 73d Cong., 2d Sess. 1 (1934); see *El Khadem v. Equity Secs. Corp.*, 494 F.2d 1224, 1227 n.7 (9th Cir.), cert. denied, 419 U.S. 900 (1974). See generally *Loomis, The Securities Exchange Act of 1934 and The Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 216-17 (1959).

24. 637 F.2d at 1150.

25. 615 F.2d 465, 470 (7th Cir. 1980). The court affirmed the dismissal of a securities action for lack of jurisdiction because the complaint regarding bank certificates of deposit did not plead securities fraud where it " 'simply describe[d] a victim whose currency was being held in a commercial transaction and not a victim-investor aspiring for profits.' "

26. 543 F.2d 38 (7th Cir. 1976). The suit was dismissed for lack of jurisdiction when the note given as part of a sale of all assets of a corporation was deemed not to be an investment where there was no reliance on efforts of others to produce profits.

27. *Id.* at 40.

28. 421 U.S. at 852-53.

[W]hat 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. In enforcement of [the federal act], it is not inappropriate that promoters' offerings be judged as being what they were represented to be.²⁹

An economic analysis of the facts in *Frederiksen* suggests that ECC was not "investing" in NSM in the statutory sense. The Seventh Circuit recognized this in its statement that the "'stock' sale was a method used to vest ECC with ownership of [the] business" rather than an investment in securities.³⁰ Consistently with this analysis, the court affirmed the district court's determination that the transaction was of a commercial nature, and was therefore not within the scope of the federal securities laws.

C. *Literal Application*

The plaintiffs attempted to justify application of the federal securities laws by advocating that the court follow the holding of the Court of Appeals for the Second Circuit in *Forman*.³¹ There, the court adopted the "literal approach" whereby the mere use of the term "stock" in connection with the transaction automatically triggered application of federal securities provisions. It was asserted that a legal presumption that a security was sold arose upon the use of the word "stock."

The *Frederiksen* court temperately rebutted the plaintiffs' argument in a four-tier sequence. The initial pitfall noted was that the language in the '33 and '34 Acts was more narrowly drawn than the plaintiffs contended. The definition of "security" in both Acts is prefaced by the phrase "unless the context otherwise requires."³² This "rubber" clause has been construed to affect the burden of proof requirement. Where the word "requires" has been stressed, the burden of showing this

29. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943), noted in 12 GEO. WASH. L. REV. 494 (1944) and 17 S. CAL. L. REV. 324 (1944).

30. 637 F.2d at 1151.

31. *Forman v. Community Servs., Inc.*, 500 F.2d 1246, 1252 (2d Cir. 1974), *rev'd sub nom. United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975). *Accord*, 1050 *Tenants Corp. v. Jakobson*, 503 F.2d 1375 (2d Cir. 1974).

32. 15 U.S.C. § 77b(1) (1976); 15 U.S.C. § 78c(a)(10) (1976).

“requirement” is placed upon the litigant asserting that the statutory language should not be interpreted literally.³³ On the other hand, a looser reading of “requires” does not necessitate a shifting of the burden.³⁴

The second segment of the court’s attack upon the plaintiffs’ “literal approach” was directed at the proper basis for delimiting the reach of the statute. The court declared that the theoretical sweep of a statute is not necessarily governed solely by the statutory terms.³⁵

Thirdly, the court recognized that there was significant case law which explicitly discarded the literal application of the definition of “security.”³⁶ The basic principle enunciated and relied upon has come to be known as the “economic reality” test, wherein the focus of inquiry is placed upon the actual substance of the sale transaction.³⁷

Finally, the court dismissed the cases cited by the plaintiffs in support of their position. Two of the three cases enumerated, *Alberto-Culver Co. v. Scherk*³⁸ and *Occidental Life Insurance Co. of North Carolina v. Pat Ryan & Associates, Inc.*,³⁹ were of minimal precedential value because they were

33. Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).

34. Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973). The language was construed in effect to mandate an examination of the factual context in which the transaction occurred before the issue could be fully resolved.

35. 637 F.2d at 1150 (quoting *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892): “[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.”)

36. The court referred to the *Forman* decision and its progeny in succeeding case law. See generally *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975); *Chandler v. Kew* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,966 (10th Cir. April 19, 1977); *Bula v. Mansfield* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,964 (D. Colo. May 13, 1977). (The decision in *Bula* was rendered just one month after *Chandler* and involved an attempted purchase of a restaurant through the acquisition of all the stock of the parent company. As in *Chandler*, the stock was held to constitute a mere indicia of ownership of the restaurant.)

37. In *Forman*, the Supreme Court conducted a two-step analysis: (1) economic substance versus form of transaction; (2) compliance with the “investment contract” test set out in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). 421 U.S. at 848.

38. 484 F.2d 611 (7th Cir. 1973), *rev'd on other grounds*, 417 U.S. 506 (1974).

39. 496 F.2d 1255 (4th Cir.) *cert. denied*, 419 U.S. 1023 (1974). The plaintiff agreed to sell the outstanding stock of its subsidiary to the defendant. After the closing, both parties became dissatisfied and Occidental sued for breach of contract in state court, but the defendant removed to federal court alleging, among other things,

rendered prior to the *Forman* decision. The third case cited, *Coffin v. Polishing Machines, Inc.*,⁴⁰ was decided after *Forman* but nevertheless was distinguishable upon its facts. The notable difference in *Coffin* was that the sale of corporate stock was utilized as a means of raising capital for profit-making purposes, which was clearly not the scenario in the *Frederiksen* case. The *Frederiksen* court summarized by declaring: "The 'stock' sale was a method used to vest ECC with ownership of that business. There was no offer of investment 'securities.'"⁴¹

D. Economic Reality Test

Next, the court scrutinized the plaintiffs' assertions that the transaction in question satisfied the requirements of the "economic reality" test announced in *Forman*. In *Forman*, the Supreme Court modified the test set out in *SEC v. W.J. Howey Co.*⁴² by holding that proof of the existence of a security involved only three elements: (1) an investment in a common venture; (2) premised on a reasonable expectation of profits; (3) which were to be derived from the entrepreneurial or managerial efforts of others.⁴³ The *Frederiksen* court took issue with the plaintiffs' claim that the first and third elements of this analysis were satisfied.

Mr. Frederiksen and ECC argued that there was an investment in a common venture because the employment agreement with the defendant entitled him to twenty percent of the gross profits of NSM and because Mr. Poloway continued

violation of the '34 Act. Emphasizing the *motive* of the defendant, the purchase was held to be a securities transaction because the defendant had a desire to buy an enterprise with a good reputation in order to expand its business.

40. 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). In *Coffin*, the district court dismissed the complaint for lack of subject-matter jurisdiction. The Fourth Circuit Court of Appeals reversed by holding that *Forman* required application of the investment contract analysis only when the stock did not meet the traditional characteristics test. 59 F.2d at 1204 (quoting *Forman*, 421 U.S. at 849).

41. 637 F.2d at 1151.

42. 328 U.S. 293, 301 (1946). *Howey* is the leading decision disregarding form for substance so as to require application of federal securities provisions. In determining whether a sales scheme involved a security, the now classic "investment contract" formula established the definition of a security as being: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) to come solely from the efforts of others.

43. 421 U.S. at 852.

to be a shareholder in NSM.⁴⁴ The court summarily dismissed this argument, referring to the test for a common enterprise as asserted in *Hirk v. Agri-Research Council, Inc.*⁴⁵ Mr. Poloway was deemed to have been a mere employee of ECC, not a participant who shared in the profits of the enterprise. The receipt of partial compensation in the form of a commission on sales did not transform the employment contract into a securities investment.

The key to determining the presence of a common enterprise was held to be the degree of control retained by the investor over the factors contributing to the venture's ultimate success.⁴⁶ As a consequence, the particular method utilized in determining the precise degree of control retained by the investor over the factors contributing to the venture's ultimate success would be crucial to an effective analysis. The court examined such relevant factors as: (1) investor expertise, (2) prior relationship of the parties and (3) economic feasibility of exploitation of the seller.⁴⁷

Next, the *Frederiksen* court addressed the third element of the "economic reality" test — that profits be derived from the efforts of others. The plaintiffs argued that, due to their inexperience in the business of selling and servicing boats, they had completely relied upon the defendant's managerial efforts and expertise. Discrediting the plaintiffs' argument, the court examined materials in the record⁴⁸ and held that they indicated an assumption of management by ECC without complete reliance on Mr. Poloway.

In addition, the employment relationship created with Mr. Poloway was held to be legally insufficient to meet the

44. See summary of "employment" and "stock purchase" agreements, *supra* note 11.

45. 561 F.2d 96, 101 (7th Cir. 1977) (a "sharing or pooling of funds" is required to satisfy the test for a common enterprise).

46. See *Tcherepin v. Knight*, 389 U.S. 332, 338 (1967).

47. A significant problem associated with the use of the phrase "common enterprise" is that the adjective "common" connotes plurality and poses the question of whether there must be a minimum number of investors in the enterprise. See *Le Chateau Royal Corp. v. Pantaleo*, 370 So. 2d 1155, 1157 (Fla. Ct. App. 1979); see also *Hannan & Thomas, The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L. J. 219, 246 (1974).

48. These materials included: (1) the employment agreement; (2) the plaintiffs' motion to disqualify the defendant's counsel; (3) an affidavit attached to the plaintiffs' motion; and (4) the stock purchase and voting trust agreement. 637 F.2d at 1153.

"source-of-profits" requirement.⁴⁹ Citing the measuring standard pronounced in *SEC v. Glenn W. Turner Enterprises*,⁵⁰ the court reasoned that ECC expected, and by contract required, the defendant to give his "best efforts" and "expertise" to NSM and ECC. But as an employee, Mr. Poloway was not responsible for "'essential managerial decisions'" affecting the conduct of the business since his efforts were specified to be within the goals and directives of ECC.⁵¹

Characterization of the nature or quality of managerial efforts must be considered in light of the other components of the *Howey* test and the policy advanced by the federal securities acts. The common theme underlying this test is the degree of control retained by the purchaser over the potential success of his investment. In this respect, the distinction between profit expectation and consumption is predicated upon investor control. Thus, Mr. Frederiksen's possession and personal exploitation of his investment gave rise to the inference of a consumptive rather than profit-seeking motive.

This categorization is also consistent with the purposes of the federal securities laws — full disclosure and prevention of fraud.⁵² Where the purchaser is in control he may lose the right to the disclosure of all relevant information affecting the success of the enterprise.⁵³ The right of control held by Mr. Frederiksen and his consequent access to information placed him in a more favorable position than most purchasers to de-

49. *Id.*

50. 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973). The court there affirmed an order granting the SEC a preliminary injunction prohibiting the offering and selling of public contracts characterized as self-improvement courses. The test of the reliance element was whether the efforts of others are undeniably significant ones which affect the failure or success of the enterprise. *Accord*, *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973) (quoting Securities Act Release No. 5211 (1971)).

51. 637 F.2d at 1153 (quoting *Turner Enterprises*, 474 F.2d at 482). Even if this transaction had intermingled security and nonsecurity aspects, the Supreme Court has made it clear that the interest obtained must have, "to a very substantial degree, the elements of an investment contract." *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 560 (1979).

52. For a synopsis of the relation of the '33 and '34 Acts see 1 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* § 4.6 (1979).

53. *See Hirsh v. DuPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975) (where the investor obtains managerial control and thereby gains access to information about the seller, he has less need of the protection provided by securities laws).

termine whether he was defrauded. From this perspective, he had a superior opportunity to minimize his losses and quickly recoup any loss occasioned by any earlier failure to detect the alleged fraud.

Finding the transaction was not within the purview of the federal securities laws, the court held that the district court was without subject matter jurisdiction and had properly dismissed the plaintiff's pendent claims.⁵⁴

II. EFFECT OF THE DECISION

The holding of the *Frederiksen* court exemplifies a strict application of the *Howey* test, viewed in light of the *Forman* decision. The ruling evidenced rejection of a purely mechanical approach.⁵⁵ The well-written opinion of Circuit Judge Specker urged that a qualitative rather than a quantitative analysis of purchaser participation be utilized to substantively gauge the existence of a security.

This approach appears continuously to produce anomalous results. For example, an instrument may be a security at one time but not at another; the definition of the instrument becomes totally dependent upon the type of transaction involved. Furthermore, some instruments may be deemed securities while other financial devices of an identical class and issuer will not since each would be classified according to its own trading patterns.⁵⁶ Both stringent and diluted applications of the *Howey* test are vulnerable to a significant criticism implicit in the observation that the federal securities laws protect sellers as well as purchasers as mandated by rule 10b-5⁵⁷ and section 14(e).⁵⁸ Since both parties are protected, a test that reaches different results depending upon which initiates the lawsuit obviously frustrates the underlying purpose of the federal securities laws.

54. A federal court cannot exercise pendent jurisdiction where the court lacks subject-matter jurisdiction of the federal claims. *United Mine Workers of America v. Gibbs*, 383 U.S. 715, 725 (1966). This principle was applied by the courts in the *Chandler* and *Forman* cases to dismiss the plaintiffs' pendent claims.

55. "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *SEC v. Howey Co.*, 328 U.S. 293, 301 (1946).

56. Hannan & Thomas, *supra* note 47.

57. 17 C.F.R. § 240.10b-5 (1981), *reprinted in* 3 FED. SEC. L. REP. (CCH) ¶ 26,744 (1980). For cases discussing the burden of proof under rule 10b-5 see *supra* note 6.

58. 15 U.S.C. § 78n(e) (1976).

It appears that federal courts have chiseled a hairline distinction between "instrument-based" and "transaction-based" sales whereby a unique solution results each time the *Howey* test is applied. A potentially viable alternative for determining the parties' need for protection would be to rely totally upon the nature of both the issue *and* the instrument.⁵⁹

Several Supreme Court decisions have given indications of a desire to restrict the scope of the securities laws to the purposes for which they were designed.⁶⁰ Since the *Howey* investment contract formula was structured to effectuate the purposes of the securities acts,⁶¹ it will suffice, for the moment, as the appropriate standard. However, the inherent ambiguity of the test affects state blue sky law⁶² adjudications since state statutory definitions of a "security" are generally interpreted by reference to federal case law construction of the term. Notwithstanding the revised form of the *Howey* test, the door is still open to the development of basic principles in the area of the law and the welcome mat is still out.⁶³

ULICE PAYNE, JR.

59. FitzGibbon, *What is a Security?: — A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 910 (1980).

60. See Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

61. Coffey, *The Economic Realities of a "Security": Is There a Meaningful Formula?*, 18 W. RES. L. REV. 367, 373 (1967).

62. The Supreme Court has held that the federal securities laws should not extend to such sale transactions because state regulation of bulk transfers under ch. 6 of the Uniform Commercial Code already governs this area. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

63. Subsequent case law uniformly applies the *Frederiksen* rationale. See *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459 (7th Cir. 1981); *Reprosystem B.V. v. SCM Corp.*, 522 F. Supp. 1257 (S.D.N.Y. 1981); *Golden v. Garafalo*, 521 F. Supp. 350 (S.D.N.Y. 1981); *Somogyi v. Butler*, 518 F. Supp. 970 (D.N.J. 1981); *Zilker v. Klein*, 510 F. Supp. 1070 (N.D. Ill. 1981).