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JUDICIAL ACTIVISM IN THE ENFORCEMENT AND  
INTERPRETATION OF THE FEDERAL SECURITIES LAWS

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Judicial activism usually arises as an issue when courts move boldly to consolidate public school districts to achieve racial balance, to free an apparently guilty felon because of a constitutional "technicality" in investigation or prosecution, to liberally construe constitutional rights of the individual despite a perceived adverse societal effect, to assume administrative responsibility for a prison system judged to be constitutionally inadequate, or to take other action which visibly affects broad political or social concerns. It is not commonly thought to be a problem in the dry, less interesting arena of business litigation. Judges who are seen as aggressively imposing their will on the resolution of controversial issues of the day are not perceived as having the same desire to enforce their personal predilections in cases where only the economic interests of more affluent litigants are at stake.

Perhaps that perception is generally accurate, or perhaps it is nothing more than a perception. But in the area of securities regulation, the courts have shown little hesitancy to find and enforce rights and liabilities and reach conclusions which are either nowhere to be found in the statutes or are based on severe contortions of the statutory

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provisions. And despite recent pronouncements by the Supreme Court of the United States that greater attention should be devoted to the language of the securities laws, the lower courts have continued to exhibit a hearing impairment and to apply the securities laws in ways unrelated to their specific provisions. In short, whatever the situation in other areas of business litigation, judicial activism is evident in the interpretation and enforcement of the federal securities laws.

## I. JUDICIAL ACTIVISM - A DEFINITION?

Any discussion of "judicial activism" is doomed to confusion without an understanding at the outset of exactly what is meant by the phrase. Some, perhaps forgetting our common law heritage, would define judicial activism as making rather than interpreting law.<sup>1</sup> Others find judicial activism present when judges fashion creative remedies to deal with difficult problems. To the more conservative, who would prefer judges who are "strict constructionists," judicial activism connotes jurists liberally interpreting and thereby expanding the law. Still others might consider judicial interpretation on an issue on which the statute is silent as an example of activism by the court.<sup>2</sup>

As used in this article, the phrase "judicial activism" is descriptive of those situations in which there is a controlling statutory provision which, by itself or with the gloss of a well-established interpretation, resolves the issue at hand but which the court chooses not to follow. Instead, the court charts a new path which disregards statutory lan-

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1. Under such a definition, common law jurists were clearly engaged in judicial activism. They would "make law" in a very real sense because their decisions, under the principle of *stare decisis*, created precedent for future cases of indistinguishable facts. *Western Union Telegraph Co. v. Call Publishing Co.*, 181 U.S. 92 (1901); *Tegtjias Development Co. v. McGoogle Brothers*, 165 F.2d 276, 279 (5th Cir. 1948); *In Re Davis' Estate*, 131 N.J.L. 161, 35 A.2d 880, 885 (1944). Chancellors in equity would qualify as judicial activists *extraordinare*. With the development of English equitable jurisdiction as an alternative to the rigid rules and procedures of the law courts, the chancellors' discretion governed and there was no "law" in equity by which an individual could measure his rights.

Equity is a roguish thing. For law we have a measure, know what to trust to. Equity is according to the conscience of him that is Chancellor and as that is larger or narrower, so is equity. Tis all one, as if they should make the standard for the measure we call a foot to be a Chancellor's foot. What an uncertain measure this would be; one Chancellor has a long foot, another a short foot, a third an indifferent foot; is the same thing in the Chancellor's conscience.

J. SELDEN, *TABLE TALK* (Pollack, ed. 1927). These comments were made in the 17th century. Chancellors historically not only "made" the law; in a very real sense they were the law.

2. There is probably no single, "correct" definition of "judicial activism." The phrase is normally used as a pejorative and thus the meaning intended by the speaker will depend upon what level of activism the speaker finds offensive.

guage or established precedent. This definition does not refer to those instances when the court is called upon to interpret and apply an ambiguous statute or even to fill in a gap where the statute fails to address a particular issue. Nor does such a definition encompass those instances when the court simply determines that a statute or precedent is distinguishable from the case at bar. This view of "judicial activism" is not, therefore, intended as a disguised criticism of the conclusions drawn by courts in the exercise of their primary duty of interpreting the laws. As used in this commentary, "judicial activism" focuses on the courts not just "making law," but doing so when the law has already been differently legislated by Congress or established by well-settled precedent.

## II. EXAMPLES OF JUDICIAL ACTIVISM

There is no better example of judicial activism in the enforcement of the federal securities laws than the manner in which section 10(b) of the 1934 Act<sup>3</sup> and Rule 10b-5 thereunder<sup>4</sup> were expanded almost beyond recognition. Section 10(b) outlawed the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . ." In other words, such manipulations or deceptions are unlawful only to the extent prohibited by Securities and Exchange Commission (SEC) rules.

The Commission's Rule 10b-5 is the cornerstone of its antifraud policy. Despite its deceptively simple language and its subsequent far-reaching scope, the Rule was born of exceedingly modest intentions. The SEC staff was informed in 1943 that the president of a Boston corporation was buying the company's stock from the shareholders for approximately \$4.00 per share. To induce their sales, he was telling the shareholders that the company was doing poorly, when in truth its earnings had quadrupled and would be \$2.00 per share for that year. Finding no other mechanism for attacking such obvious fraudulent ac-

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3. 15 U.S.C. § 78(j)(b) (1982).

4. 17 C.F.R. 240.10b-5 (1985). The Rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

tivity,<sup>5</sup> a member of the staff drafted Rule 10b-5 by combining section 10(b) of the 1934 Act and section 17 of the 1933 Act. The Commission adopted the Rule that same day.<sup>6</sup>

The later expansion of the Rule by judicial decision is nothing short of spectacular and would, by almost anyone's definition, qualify as judicial activism. While the Rule spoke in terms of fraud or deceit, negligent misrepresentations were eventually found to be a violation.<sup>7</sup> And although the Rule rendered omissions of material facts unlawful only when they caused other statements to be misleading,<sup>8</sup> the courts nevertheless imposed a "disclose or abstain" rule which resulted in liability even when the defendant in possession of material information made absolutely no statements whatsoever.<sup>9</sup> The courts were also quick to imply a private cause of action for those who claimed to have been harmed by a violation,<sup>10</sup> despite the fact that in adopting the Rule the

5. Both sections 17(a) and 12(2) of the Securities Act of 1933, 15 U.S. §§ 77(1) and 77(q)(a) (1982), which prohibit fraud only in the offer or sale of securities, are limited to seller's fraud.

6. Comments of Milton V. Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

7. See, e.g., *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (negligence sufficient); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963), (knowledge not required). That conclusion was changed when the Supreme Court of the United States decided that violations of the Rule require scienter (intentional or perhaps reckless misconduct) and that simple negligence would not be actionable. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). See also *Aaron v. SEC*, 446 U.S. 680 (1980).

8. The Rule expressly proscribes only "half-truths." Omissions of material facts, when unaccompanied by other statements, are outside the express terms of the Rule.

9. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). This result was later modified when the Supreme Court held that a trader had not violated 10b-5, despite his failure to reveal material non-public information in advance of trading, if he had no duty to speak. *Chiarella v. U.S.*, 445 U.S. 222 (1980). It is arguable that total silence is outlawed by subsection 1 (as a "device, scheme or artifice to defraud") or by subsection 3 (since it would "operate as a fraud") and, therefore, that this is a matter of statutory construction rather than judicial activism. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 197-99 (1963); 1 A. BROMBERG and L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* 51 (1985); 3 LOSS, *SECURITIES REGULATION* 1439 (1961). But where the Rule expressly provides for liability for omissions only in limited circumstances, it obviously is not a reflection of the drafters' intent to construe the more general provisions of the same rule as also proscribing that same activity but without those same limitations. Stretching the language of the Rule in this fashion is an act of judicial activism beyond simple statutory interpretation.

10. See, e.g., *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). After 25 years of subsequent lower court decisions inferring such a private cause of action, *Kardon* was affirmed without discussion by the Supreme Court. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972); *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). The Supreme Court has since implied, however, that absent that history it would not now choose to create such a cause of action. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975).

Commission had no intention of affecting private remedies.<sup>11</sup>

By focusing on one seemingly insignificant phrase in both the statute and the Rule the true nature of judicial modification of the law can be seen. Both section 10(b) and Rule 10b-5 limit their scope to transactions "in connection with the purchase or sale of any security."<sup>12</sup> Despite the apparent lack of any legislative history explaining the meaning of this phrase,<sup>13</sup> it obviously is intended to require some link between the material misrepresentation or omission and a securities transaction. And although the language arguably permits a looser link than do other provisions of the securities laws,<sup>14</sup> it nevertheless requires some connection with a securities trade.

Judicial decisions have interpreted this phrase so loosely that they appear almost to have ignored it. Consider, for example, the now-fa-

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11. Mr. Milton Freeman, the drafter of Rule 10b-5, stated that "[i]t had no relation in the Commission's contemplation to private proceedings." Freeman, *supra* note 6, at 922. The Rule was specifically designed only to provide the Commission with a tool for reaching insider trading based upon misrepresentation. *Id.* Indeed, the very circumstance which gave rise to the Rule, outright fraudulent misrepresentation of material facts by the director-purchaser to the stockholder-sellers, was already actionable at common law fraud by the victim. *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932).

Private causes of action judicially implied under other provisions of the securities laws also evince an activist bent. Most notable in this regard is *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964), which held that private parties have a right to bring suit for legal or equitable relief for alleged violations of the statutes and regulations pertaining to solicitation of proxies. The essence of the Court's decision is captured in one brief quotation from the opinion: "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." *Id.* at 432. In other words, the private action was implied since it would aid in attaining the objectives of the law. Regardless of whether the conclusion is correct, the Court clearly made the legislative judgment of what sanctions for violation are appropriate. Even the example cited by the Court, antitrust treble damages, is expressly provided by statute (Clayton Act § 4, 15 U.S.C. § 15 (1982)). The private cause of action decisions, since they dealt with statutes silent on the subject, do not fall within the strict definition of judicial activism used herein of reaching a result contrary to what the statute provides. They are nonetheless examples of decisions which intrude on the legislative function. Some comfort can be taken from *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11 (1979), and *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), both of which rejected private causes of action under the securities laws, reasoning generally that closer attention must be paid to the statutory provisions and the intentions of congress.

12. 15 U.S.C. § 78(j)(b) (1982). 17 C.F.R. § 240.10b-5 (1985).

13. 3 A. BROMBERG and L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD*, § 7.6, at 190.21 (1985).

14. *Id.* Compare section 17(a), which prohibits fraud "in the offer or sale of any securities." 15 U.S.C. § 77(9) (1982) and section 12, 15 U.S.C. § 77(l) (1982), which extends liability "to any person who offers or sells a security." *But see* *United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979), where the Court stated: "[W]e are not necessarily persuaded that 'in' [as used in section 17(a)] is narrower than 'in connection with.'"; *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir. 1984).

mous Second Circuit Court of Appeals decision in *SEC v. Texas Gulf Sulphur Co.*,<sup>15</sup> where the court considered whether a materially deficient corporate press release violated Rule 10b-5. Neither the corporation nor any of the corporate officers responsible for the release traded in corporate securities after its preparation or dissemination to the press. And although there had been significant insider trading earlier, after the press release insider trading was minimal and apparently without complicity on the part of the corporation. Thus no connection was drawn between the press release and the unlawful trading. This did not stop the court, however, from finding that the press release was issued "in connection with the purchase and sale" of a security. The court reasoned, in effect, that the purpose of the section was broader than its language. After characterizing the Congressional purpose broadly as the protection of investors and noting that investors can be harmed even if corporate action is not in connection with trading by the corporation or its agents,<sup>16</sup> the court held that a corporate misrepresentation or omission of a material fact is "in connection with" a securities transaction if it is made "in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media. . . ."<sup>17</sup>

Under such a reformulation of the "in connection with" requirement, it is not even necessary to a finding of a violation that a trade has taken place. All that is required is that the corporate action be "reasonably calculated to influence" investors, without any apparent require-

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15. 401 F.2d 833 (2d Cir. 1968); *cert. denied*, 394 U.S. 976 (1969).

16. Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public and to secure fair dealing in the securities markets would be seriously undermined by applying such a gloss onto the legislative language. . . . Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose. We do not believe that Congress intended that the proscriptions of the Act would not be violated unless the makers of a misleading statement also participated in pertinent securities transactions in connection therewith, or unless it could be shown that the issuance of the statement was motivated by a plan to benefit the corporation or themselves at the expense of a duped investing public.

*Id.* at 860.

17. *Id.* at 862.

ment that such influence in fact occurred by causing any trading. In other words, while both the statute and the Rule require that the alleged fraud be committed "in connection with the purchase and sale of any security," the court suggested that a violation could be present even in the absence of any purchase or sale.<sup>18</sup> By this construction the court expanded 10b-5 to become a monitor of the accuracy of corporate pronouncements regardless of whether, in fact, those pronouncements have a demonstrable connection with any purchase or sale.<sup>19</sup>

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18. Of course, in order for a private litigant to bring an action under 10b-5, he must prove that he bought or sold. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952). But there is no similar restriction on the SEC. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 751 n.14 (1975); *SEC v. National Securities, Inc.* 393 U.S. 453 467 n.9 (1969); *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1151 (D.C. Cir. 1978). Standing is also not an issue in criminal actions. *United States v. Charnay*, 537 F.2d 341, 349 n.11 (9th Cir. 1976); *United States v. Persky*, 520 F.2d 283, 288 n.9 (2d Cir. 1975). Thus, although an individual plaintiff may lack standing unless he actually bought or sold, such an actual purchase or sale is not a prerequisite to finding a violation.

Ironically, these two conclusions on standing and scope are both based upon the same "in connection with" proviso. While that phrase is construed quite strictly when standing is the issue, it is interpreted very liberally when the scope of the Rule is at issue.

19. *See e.g.*, *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968). Despite the fact that the securities laws already provide express remedies for many corporate misstatements (*see, e.g.*, § 18 of the 1934 Act, 15 U.S.C. § 78(r) (1982)), the duplication between 10b-5 and those express remedies apparently will not affect the scope of the former. *See Herman & McLean v. Huddleston*, 103 S. Ct. 683 (1983), which held that an implied private right of action for fraud under section 10(b) exists even when an express remedy may also be available under section 11 of the Securities Act of 1933.

Even where a purchase or sale is present, the connection with the fraud is sometimes stretched beyond recognition. In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the fraud was that the purchaser of one hundred percent of the stock of an insurance company used the insurance company's assets to pay for the acquisition. After acquiring control of the issuer, the purchaser sold the issuer's U.S. Treasury bonds. The proceeds were credited to one of the issuer's bank accounts against which the purchaser's original check in payment for the insurance company's stock was charged. Despite the fact that the essence of the wrongdoing was the misappropriation of the proceeds of the securities sale, which took place after the security sale was complete, the Court nevertheless found sufficient connection between the security transaction and the fraud to uphold liability under 10b-5.

The reference in that decision to the plaintiff having "suffered an injury as a result of deceptive practices touching its sale of securities as an investor" (emphasis added) *Id.* at 12-13, contributed to the broad interpretation of the phrase. *But see Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 941-45 (2d Cir. 1984).

The "in connection with" requirement has long been deemed satisfied when the fraud consists of misrepresentation of the asset sold rather than the security received in payment. *See, e.g.*, *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662, 663-64 (2d Cir. 1971); *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195, 200-03 (5th Cir. 1960); *Errion v. Connell*, 236 F.2d 447, 454-55 (9th Cir. 1956); *MacAndrews & Forbes Co. v. American Barmag Corp.*, 339 F.Supp. 1401, 1405-07 (D.S.C. 1972). But so long as the misrepresentation was integral to the securities sale, this result does not exhibit judicial activism.

It may be that a trend is developing to construe the "in connection with" phrase more strictly,



Another example of judicial activism appears in *United States v. Wolfson*.<sup>20</sup> The primary purpose of the Securities Act of 1933 is to protect investors in distributions of securities by issuers.<sup>21</sup> But the statute is not expressly limited to that context. In fact, its requirement of disclosure through registration is universally extended to "any person" who offers or sells "any security."<sup>22</sup> The only provision in the Act which relieves the small trader from compliance with the disclosure requirements is section 4(1) which exempts therefrom "transactions by any person other than an issuer, underwriter or dealer."<sup>23</sup> Since the typical trader in the secondary market is neither an issuer, underwriter, nor dealer he is exempt and the disclosure requirements of the Act are effectively limited to distributions by the issuer or its affiliates.

But in *Wolfson*, the court skewed the intended statutory result. *Wolfson* involved a secondary distribution<sup>24</sup> by a person in control of the issuer. The dilemma presented to the court was that while the '33 Act clearly provided for the responsibility of the broker who participates in the secondary distribution,<sup>25</sup> liability of the controlling person, the individual actually responsible for the secondary distribution, is omitted. Since the controlling person is not an underwriter or dealer,

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at least to require a causal connection between the fraud and the purchase or sale. See, e.g., *Keitchum v. Green*, 557 F.2d 1022, 1022-1029 (3d Cir. 1977); *Williamsport Firemen Pension Boards I & II v. E. F. Hutton & Co.*, 567 F. Supp. 140 (M.D. Pa. 1983); *Angelastro v. Prudential-Bache Securities, Inc.*, 575 F. Supp. 270, 272-73 (D.N.J. 1983), *Natowitz v. Mehlman*, 567 F. Supp. 942 (S.D.N.Y. 1983).

20. 405 F.2d 779 (2d Cir. 1968), cert. denied, 394 U.S. 946 (1969).

21. *Report of Special Study of the Securities Markets*, SECURITIES AND EXCHANGE COMMISSION, Part I, 9 (1963).

22. Securities Act of 1933, § 5, 15 U.S.C. § 77(e) (1982).

23. This provision is designed to exempt routine trading transactions from the registration and disclosure requirements of section 5 of the 1933 Act. *SEC v. Holschuh*, 694 F.2d 130, 137-38 (7th Cir. 1982); *Preliminary Notes to Rule 144*, 17 C.F.R. § 230.144 (1985).

24. A "secondary distribution" is a sale of securities through a broker-dealer by one who controls, is controlled by or is under common control with the issuer. Disclosures are required in secondary as well as original distributions since the same dangers are presented by both. See *In the Matter of Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

25. The statutory basis for requiring registration in a secondary distribution is the definition of underwriter in section 2(11) of the 1933 Act, 15 U.S.C. § 77(b)(11) (1982). Included within the definition of "underwriter" is "any person who . . . offers or sells for an issuer [and for purposes of this definition, issuer includes a controlling person of the issuer] in connection with the distribution of any security . . ." Thus, the broker-dealer becomes an underwriter, can no longer claim the dealer's exemption of section 4(3), 15 U.S.C. § 77(d)(3) (1982), and is not exempt under section 4(1) (15 U.S.C. § 77(d)(1) (1982)) from the registration requirements. The "brokers' transaction" exemption of section 4(4), 15 U.S.C. § 77(d)(4) (1982), is also unavailable because it exempts only trading transactions, not distributions. *In the Matter of Ira Haupt*, 23 S.E.C. 589 (1946).

and except for the limited purpose of defining who is an underwriter,<sup>26</sup> is also not an issuer, section 4(1) appears to exempt the controlling person from responsibility. The court avoided this result by holding that 4(1) exempts transactions, and that since the broker in a secondary distribution is an underwriter the exemption for the entire transaction was lost. Therefore, those responsible for the non-exempt sale without registration, including the controlling person, violated the Act, and would share liability.

In reaching this result, the court purported to apply the 4(1) exemption literally to "transactions" rather than classes of people.<sup>27</sup> As a matter of statutory construction in the abstract the proper interpretation of 4(1) is perhaps arguable. But this question did not arise in the abstract. As indicated above, 4(1) is the provision which exempts small traders from registration and effectively limits registration to distributions. But the reasoning of *Wolfson*, if carried to its logical next step, would change that. If 4(1) truly exempts transactions rather than classes of people, virtually every trade in the secondary market, since each will utilize a broker-dealer,<sup>28</sup> must be preceded by registration. And even though the broker may find an exemption for his participation, that will not relieve the seller of his obligation.<sup>29</sup> Consequently, by stretching the accepted meaning of 4(1) to avoid an unfortunate result in one case, the court brought into question one of the fundamentals of the 1933 Act.<sup>30</sup>

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26. See *supra* note 25.

27. See also, SEC v. Holschuh, 694 F.2d 130, 137 (7th Cir. 1982); SEC v. Murphy, 626 F.2d 633, 648 (9th Cir. 1980); SEC v. Culpepper, 270 F.2d 241, 247 (2d Cir. 1959); SEC v. Chinese Consolidated Benevolent Association, Inc., 120 F.2d 738, 741 (2d Cir. 1941). In each of these decisions, as in *Wolfson*, the transaction at issue was a distribution of securities and not the type of routine trading transaction intended to be exempt under section 4(1). The irony is that *Wolfson*, in attempting to limit the section 4(1) exemption to routine trading transactions, employed reasoning which would foreclose the exemption to those transactions.

28. Since brokers are included within the definition of "dealer" in section 2(12) of the 1933 Act, 15 U.S.C. § 77(b)(12) (1982), the participation by a broker in a securities transaction will have the same effect on the availability of section 4(1) as will participation by an underwriter.

29. The broker might successfully claim the brokers' transaction exemption of section 4(4), 15 U.S.C. § 77(d)(4) (1982), or perhaps the exemption from certain dealer transactions under section 4(3), 15 U.S.C. § 77(d)(3) (1982). But such exemptions for the broker, according to *Wolfson*, exempt only the broker. Others must find their own exemption. 405 F.2d at 782. See also S.E.C. Rel. 131 (1934).

30. *Wolfson* has not been taken to its logical extreme. There is no hint that non-affiliates of the issuer must register before they can sell securities of the issuer in the secondary market, even though they utilize the services of a broker-dealer in doing so. Apparently the reasoning of *Wolfson*, at least as it might apply in transactions other than issuer and secondary distributions, has been rejected. Professor Loss, for example, without distinguishing the reasoning of *Wolfson*, states: "[W]hen the principal is not an issuer, underwriter or dealer, a § 4(1) exemption for the

One of the most glaring contortions of the statutory language may be found in judicial interpretations of the meaning of an exempt private placement. Section 4(2) of the 1933 Act<sup>31</sup> exempts from the registration and disclosure obligations "transactions by an issuer not involving any public offering." In other words, public offerings are covered while non-public or private placements are not. The nature of the exemption lies, therefore, in the difference between public and private placements.

In common parlance, private placements should be viewed in terms of numbers. According to the standard definition of the term "private,"<sup>32</sup> a private placement should be one that is not open to the public at large but is limited to a select few. Like a private party or a private sale by a retailer, a private placement should be defined as one where only a certain, limited number of individuals are invited to participate. A public offering by contrast, should be seen as one open indiscriminantly to a much larger group, possibly although not necessarily, to the world at large.<sup>33</sup> That is not to say that it should always be easy to differentiate between public and private offerings, or that a hard and fast line could be drawn at a particular number of offerees.<sup>34</sup> But definitionally and conceptually, the distinction between the two is numerical.

In 1953, the Supreme Court of the United States gave an entirely different meaning to the exemption under 4(1). In *SEC v. Ralston Purina Co.*,<sup>35</sup> the common definition of "private" was disregarded and the court chose instead to interpret that term in light of the statutory purpose. Despite the absence of any specific reference in the legislative history to the definition of public or private offering, the Court based its decision on the statement that the exemptions were carved out for those transactions "where there is no practical need for . . . [the bill's]

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principal's part of the transaction goes hand in hand with a § 4(4) exemption for the broker's part." L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 402 (1983).

31. 15 U.S.C. § 77(d)(2) (1982).

32. WEBSTER'S, THIRD NEW INTERNATIONAL DICTIONARY (unab. 1971) defines "private" in this context alternatively as "intended for or restricted to the use of a particular person or group or class of persons," and "affecting an individual or small group."

33. In this context, "public" is defined as "accessible or shared by all members of the community," *Id.*

34. To help draw such lines in individual cases, at one time the courts looked to whether the individuals selected bore some reasonable relation to the purpose for which the selection is made. See, e.g., *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699, 701 (9th Cir. 1938). Thus, in order to be public, an offering did not have to be open to the whole world. An offering to all residents of Chicago for example, was a public offering since the offerees are selected without any relation to the purpose of the offer. *Id.* As a result, the offer was open to too many people to be considered private.

35. 346 U.S. 119 (1953).

application, or where the public benefits are too remote."<sup>36</sup> Following that theme, the Court limited exempt private placements under 4(1) to those where the offerees do not need the protection of the Act and can fend for themselves.<sup>37</sup> In doing so, the Court specifically rejected a quantitative test.<sup>38</sup>

As redefined in *Ralston Purina*, the availability of the private placement exemption can be determined only after a number of subjective inquiries concerning the individual transaction.<sup>39</sup> But such factors as sophistication of offerees and access to or availability of relevant information have little to do with the concept of whether an offering is public or private. Although as a practical matter private placements should have some reasonable limit on the number of offerees,<sup>40</sup> the Court held the existence of a public or private offering cannot be determined by looking to whether it is open only to a select few. In fact, an offering to only two, and perhaps an offering limited to even one offeree, is not necessarily private under this analysis.<sup>41</sup> In short, *Ralston Purina* took the comparably straightforward concept of "private" as it appeared in the statute and changed it to something quite different and much less workable.<sup>42</sup>

### III. THE SUPREME COURT DEMANDS CLOSER ADHERENCE TO STATUTORY LANGUAGE

In the middle 1970's the Supreme Court of the United States be-

36. H.R. REP. NO. 85, 73d Cong., 1st Sess., 1 (1933).

37. 346 U.S. at 125. It is not at all clear that even if resort to congressional intent is necessary in order to define "private placement," the result reached in *Ralston Purina* is the correct one. Drawing upon the same quotation relied upon by the Court, *see supra* note 36, it may be that Congress determined that in a private placement to a relatively few offerees the public benefits of registration are simply "too remote."

38. "But the statute would seem to apply to a 'public offering' whether to few or many. . . . [T]here is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." *Id.*

39. *See, e.g.,* Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977); Schneider, *The Statutory Law of Private Placements*, 14 REV. OF SEC. REG. 869 (1981); *Section 4(2) and Statutory Law: A Position Paper of the Federal Regulation of Securities Committee, Section of Corporation, Banking and Business Law, of the American Bar Association*, 31 BUS. LAW. 485 (1975).

40. *Schneider, supra* note 39.

41. *See, e.g.,* Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978).

42. In adopting Rule 146, the Commission commented that the private placement exemption as developed under *Ralston Purina* and subsequent cases resulted in uncertainty and misconceptions about its availability. The purpose of the Rule was to provide more objective standards and greater certainty in the application of the exemption. S.E.C. Rel. 547 (1974). Ironically, Rule 146 was subsequently replaced by Rule 506 of Regulation D in order to simplify and clarify the exemption. S.E.C. Rel. 6389 (1982).

gan to take a more restrictive view of the scope of the federal securities laws.<sup>43</sup> Of significance for present purposes are those decisions which commanded closer attention to the language of the statutes themselves. In deciding that some element of intent or recklessness beyond mere negligence was required for liability under Section 10(b) of the 1934 Act and Rule 10b-5, the Court in *Ernst & Ernst v. Hochfelder*,<sup>44</sup> noted that, "[t]he starting point in every case involving construction of a statute is the language itself."<sup>45</sup> Then the Court pronounced that "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [Federal Securities] Acts must therefore rest primarily on the language of that section."<sup>46</sup> More pointedly, the Court held that "the language of a statute controls when sufficiently clear in its context,"<sup>47</sup> and, in that event, further inquiry into concerns of policy are rendered unnecessary.<sup>48</sup>

Essentially the same adherence to statutory language has been demanded in subsequent decisions of the United States Supreme Court as well. In *Santa Fe Industries v. Green*,<sup>49</sup> the Court reiterated the need to have the language of the statute control its interpretation and to avoid adding a gloss to the statute's operative language different from its commonly accepted meaning.<sup>50</sup> In *Touche Ross & Co. v. Redington*,<sup>51</sup> where it was asked to imply a private cause of action for viola-

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43. The opening salvo in this attack on the expanding jurisprudence of the federal securities laws was fired in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), when the Court held that a private Rule 10b-5 action could only be maintained by a purchaser or seller of securities. The Court observed "that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Id.* at 739. This was based upon a fear that even a frivolous securities claim, because of possible abuse of liberal discovery provisions and the threat of disruption of the defendant's normal business activity, may have a settlement value disproportionate to its prospect of success. To that extent, the Court described securities litigation as "a social cost rather than a benefit." *Id.* at 741. And in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), the Court refused to extend Rule 10b-5 to transactions involving internal corporate management. The Court was reluctant to liberally construe the scope of the Rule for fear of creating a broad federal corporate law which could interfere with and perhaps preempt well-established state corporate law.

44. 425 U.S. 185 (1976).

45. *Id.* at 197 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)).

46. *Id.* at 200.

47. *Id.* at 201.

48. *Id.* "As we find the language and history of § 10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy" set forth by the parties, that may have influenced the lawmakers in their formulation of the statute." *Id.* at 214 n.33.

49. 430 U.S. 462 (1977).

50. *Id.* at 472.

51. 442 U.S. 560 (1979).

tion of section 17(a) of the 1934 Act, the Court again stated that in matters of statutory construction the analysis must begin with the language of the statute itself.<sup>52</sup> The Court rejected an implied cause of action because there was no basis in the language of the statute for inferring one.<sup>53</sup> Likewise, in *Transamerica Mortgage Advisors, Inc. v. Lewis*,<sup>54</sup> the Court responded to a request to imply a cause of action under the Investment Advisors Act<sup>55</sup> by stating that in such matters of statutory construction "we begin with the language of the statute itself."<sup>56</sup> Later, in *Rubin v. United States*,<sup>57</sup> when the Court was asked to decide whether a pledge of stock was a sale under section 17(a) of the 1933 Act, the Court noted: "[w]e begin by looking to the language of the Act,"<sup>58</sup> and "[w]hen we find the terms of a statute unambiguous, judicial inquiry is complete, except 'in rare and exceptional circumstances.'"<sup>59</sup>

The unmistakable message of these decisions is that closer attention must be paid to the language chosen by Congress. When the meaning of that language is clear, the judicial obligation is to enforce the language as written. In such circumstances courts should not look behind the statutory provisions in order to ascertain and enforce the perceived purpose or policy of the statute if to do so would result in an application different from that suggested by the statute itself.<sup>60</sup> The

52. *Id.* at 568.

53. *Id.* at 571.

54. 444 U.S. 13 (1979).

55. 15 U.S.C. § 80b-1 (1982), *et seq.*

56. 444 U.S. at 16. *See also* International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).

57. 449 U.S. 424 (1981).

58. *Id.* at 429.

59. *Id.* at 430. The Court held that a pledge is an "offer or sale" of a security for purposes of section 17(a) of the 1933 Act. *Id.* at 431.

60. This is nothing more than the well-established tenet of statutory construction that unambiguous statutes must be given effect according to their plain and obvious meaning. *United States v. Sullivan*, 332 U.S. 689 (1948).

The Supreme Court's message was recently reaffirmed in *Sedima, S.P.R.L. v. Imrex Co. Inc.*, 105 S. Ct. 3275 (1985). Although the Court in *Sedima* was considering the provisions of the Racketeer Influenced and Corrupt Organization Act (RICO), 18 U.S.C. §§ 1961-1968 (West 1982) and not one of the federal securities laws, the decision nevertheless has significance in the securities area because offenses involving securities fraud are included in the definition of prohibited "racketeering activity." § 1961(1). Concerned about abuse of civil damage provisions of RICO by private plaintiffs, the lower court attempted to narrow the availability of civil RICO by permitting private actions only against defendants who had been previously convicted of criminal charges, and only where a "racketeering injury" had occurred. The Supreme Court rejected both conditions because they simply were not to be found in the statute. While expressing understanding of "the [lower] court's concern over the consequences of an unbridled reading of the statute," 105 S. Ct. at 3278, and recognizing "that, in its private civil version, RICO is evolving into some-

implication, of course, is that Congress should be taken at its word. If the statute does not accurately reflect congressional intent it is for Congress, not the courts, to correct the language.

#### IV. SUPREME COURT'S MESSAGE FALLS ON DEAF EARS

Subsequent decisions construing and applying the federal securities laws suggest, however, that the lower federal courts have not heeded this command from the nine Justices in Washington. In fact, some of those decisions leave the impression that the inferior courts, at best, did not hear the message or, at worst, chose to ignore it. A prime example is the development of the so-called "sale of business" doctrine.

Numerous federal district and circuit courts have held that when a 100 percent or controlling interest in a corporation is sold to a single purchaser the transaction does not involve the sale of a security, and thus does not implicate the federal securities laws, despite the fact that the sale is accomplished by the transfer of corporate stock.<sup>61</sup> While numerous reasons have been advanced in support of this result, the doctrine is essentially founded on the proposition that in reality the transaction is a sale of business which for convenience is accomplished through a sale of stock. Since for practical purposes the transaction is indistinguishable from a direct sale of assets and assumption of liabilities, to which the securities laws would be inapplicable, supporters of the doctrine reason that the securities laws should not be triggered simply because the parties chose to accomplish their transaction by transferring stock.<sup>62</sup> The economic reality is that the transaction is a sale of a business rather than a sale of securities.<sup>63</sup>

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thing quite different from the original conception of its enactors," 105 S. Ct. at 3287, the Supreme Court concluded that the remedies fashioned below constituted a form of "statutory amendment" not "appropriately undertaken by the courts." *Id.* In short, the Court refused to allow a judicial rewriting of the statute in order to achieve what the lower court judges felt was a better result.

61. See, e.g., *Christy v. Cambron*, 710 F.2d 669 (10th Cir. 1983); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981); *Bula v. Mansfield*, Fed. Sec. L. Rep. (CCH) ¶ 96, 964 (D. Colo. 1977); *Chandler v. Kew, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 96, 965 (D. Colo. 1975), *aff'd*, Fed. Sec. L. Rep. (CCH) ¶ 96, 966 (10th Cir. 1977). *But see* *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984); *Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227 (2d Cir. 1982); *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir. 1979).

62. See, e.g., *Zilker v. Klein*, Fed. Sec. L. Rep. (CCH) ¶ 97, 992 (N.D. Ill. 1981); *Chandler v. Kew, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 96, 965 (D. Colo. 1975); *aff'd*, Fed. Sec. L. Rep. (CCH) ¶ 96, 966 (10th Cir. 1977).

63. See, e.g., *Landreth Timber Co. v. Landreth*, Fed. Sec. L. Rep. (CCH) ¶ 99, 705 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985).

In order to reach this result the courts have simply taken the well-worn *Howey*<sup>64</sup> test for the definition of an "investment contract,"<sup>65</sup> renamed it the "economic realities" test,<sup>66</sup> applied it to stock as well as investment contracts,<sup>67</sup> and concluded that the corporate stock transferred in a sale of business is not a security under that definition.<sup>68</sup> Under the "economic reality" test, an instrument is a security if it constitutes an investment of money in a common enterprise with the expectation of profit due primarily from the efforts of others.<sup>69</sup> The stock sold in a sale of business usually fails to conform to this definition in two respects. First, because there is often a single purchaser in a sale of business there is no common enterprise in which funds of numerous investors are pooled.<sup>70</sup> Second, since the purchaser of an entire enterprise usually intends to take an active role in the business, the profits will not be due to the efforts of others.<sup>71</sup>

It is not the purpose of this commentary either to criticize or to defend the wisdom of the sale of business doctrine. Critics and supporters of the doctrine are numerous and vocal.<sup>72</sup> But strictly as a neutral

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

65. The statutory definition in both the 1933 and 1934 Acts consists of a list of different types of interests and instruments which qualify as "securities." The list includes a number of specifically identified instruments, such as notes, stocks or bonds, and includes, as a general catch-all, "investment contract." The Court in *Howey* was solely concerned with whether the interests under consideration fell within the "investment contract" category.

66. See, e.g., *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981). The *Howey* test is essentially the same as the "economic realities" test supporting the sale of business doctrine. Note, *Repudiating the Sale of Business Doctrine*, 83 COLUM. L. REV. 1718, 1727 (1983).

67. See, e.g., *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981); *Oakhill Cemetery of Hammond, Inc. v. Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981); *Bula v. Mansfield*, Fed. Sec. L. Rep. (CCH) ¶ 96, 964 (D. Colo. 1977). But see *Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983).

68. See cases cited *supra* notes 62, 66 and 67.

69. See, e.g., *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975); *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946).

70. See, e.g., *Frederiksen v. Poloway*, 637 F.2d 1147, 1152-54 (7th Cir. 1981); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 464 (7th Cir. 1981).

71. See cases cited *supra* note 70. See also *Landreth Timber Co. v. Landreth*, Fed. Sec. L. Rep. (CCH) ¶ 99, 705 (9th Cir. 1984); *rev'd*, 105 S. Ct. 2297 (1985).

72. Support for the doctrine may be found in Easley, *Recent Developments in the Sale-Of-Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 BUS. LAW. 929 (1984); Seldin, *When Stock Is Not a Security: The "Sale of Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637 (1982); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock Is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982); Note, *Function over Form: The Sale of Business Doctrine and the Definition of 'Security'*, 63 B.U.L. REV. 1129 (1983). Criticism of the doctrine or the reasoning behind it is voiced in Blenke, *Federal Securities Laws and Their Applicability to the Sale of a Business: An Appeal for Regulatory Action*, 17 J. MAR. 393 (1984); Darrell, *Rede-*



observation, the courts which have adopted the doctrine have clearly departed from the statute. Both the 1933 and 1934 Acts define "security" as including "stock."<sup>73</sup> Indeed, corporate common stock is the quintessential form of investment security.<sup>74</sup> Whatever else may be said about the doctrine, it unquestionably exemplifies an instance when a security, so identified in the statute and commonly understood, is determined not to be a security.

In their decisions adopting the doctrine, the courts do not admit to ignoring the statutory language but instead rationalize their actions. The courts assert, for example, that the economic realities test must be applied to all interests, not just to "investment contracts" for which it was originally devised.<sup>75</sup> However, the authority for that assertion is a decision which first held that the instrument involved was not "stock" as that term is understood and used in the securities laws.<sup>76</sup> In addition,

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*fining a 'Security': Is the Sale of a Business Through a Stock Transfer Subject to the Federal Securities Laws?* 12 SEC. REG. L. J. 22 (1984); Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99 (1982); Prentice & Roszkowski, *The Sale of Business Doctrine: New Relief from Securities Regulation or a New Haven for Welshers?* 44 OHIO ST. L. J. 473 (1983); Shneider, *The Sale of a Business Doctrine - Another View*, 37 SW. L. J. 461 (1983); Note, *Repudiating The Sale-Of-Business Doctrine*, 83 COLUM. L. REV. 1718 (1983).

73. 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, any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

Securities Act of 1933, section 2(1), 15 U.S.C. § 77b(1) (1982). The corresponding definitions in the Securities Exchange Act of 1934, section 3(a)(10), 15 U.S.C. § 78c(a)(10) (West 1982), and in many state securities laws (*see, e.g.*, the Arkansas Securities Act, § 13(1), ARK. STAT. ANN. § 67-1247(1)(e) (1985 Cum. Supp.)) are for this purpose indistinguishable.

74. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 212 (1983).

75. *See supra* note 67. The primary basis for that conclusion is *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), in which the Supreme Court commented that the *Howey* test, "embodies the essential attributes that run through all of the Court's decisions defining a security." *Id.* at 852. *Canfield v. Rapp & Son Inc.*, 654 F.2d 459, 464 (7th Cir. 1981). This sentiment has been interpreted to mean that "the economic realities-investment contract test is universally applicable as a standard for determining securities jurisdiction." *Easley, supra* note 72, at 935.

76. The first portion of the *Forman* opinion was devoted to a determination of whether the "stock" which was sold was in fact "stock" as that term is used in the statutory definition of security. The Court concluded that since the "stock" in question did not possess those "characteristics traditionally associated with stock," because it was not negotiable, could not be pledged or

the position taken by the lower federal courts would effectively require erasing the long list of enumerated examples of "securities" in the statutory definition and replacing it with the single economic realities test. In effect, one term in the list, "investment contract," would replace the entire definitional list.<sup>77</sup>

A second rationalization for departing from the statutory language is based upon the phrase "unless the context otherwise requires," which precedes the statutory definition. The reasoning of the courts is that the context of a sale of an entire business suggests that the transaction should not be deemed to involve a security. In sales of an entire business, the purchaser is not a passive investor but is, usually, one who will be active in the managerial affairs of the business, and, because of his economic bargaining position, will not require the protections of the securities laws.<sup>78</sup> Furthermore, since the sale of business through the sale of stock is essentially the same as a sale of assets and assumption of liabilities, enforcing the securities laws in the former but not the latter situation is illogical.<sup>79</sup> What the courts are really saying is that the context of a sale of business renders application of the securities laws unnecessary. In other words, the cases have created an exemption for a type of transaction in which the protections of the Act are seen as unnecessary; i.e., a transactional exemption.<sup>80</sup> And unlike the transac-

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hypothecated, conferred no voting rights, would not appreciate in value, and was purchased solely to acquire living space and not to invest for profit, it was not a security. 421 U.S. at 851. Only after reaching that conclusion did the Court consider whether the "stock" might also be an "investment contract" for which the *Howey* test would be helpful. The opinion simply does not stand for the proposition that investment contract analysis should be applied to traditional corporate "stock." See *Golden v. Garafalo*, 678 F.2d 1139, 1143-44 (2d Cir. 1982). But see *Easley*, *supra* note 72, at 949 n.164.

77. *Golden v. Garafalo*, 678 F.2d 1139, 1144 (2d Cir. 1982). Since the *Howey* test was devised solely to define "investment contract," see *supra* note 65, if that test is used as the sole definition of "security," the result is that "investment contract" is the only relevant term in the statutory definition. As stated by one author, "[t]he Court's analysis [in *Forman*] suggests that the economic realities-investment contract test is universally applicable as a standard for determining securities jurisdiction." *Easley*, *supra* note 72, at 935. Another commentator has added that each of the instruments listed in the statutory definition is "both functionally and definitionally, an investment contract, and there is, therefore, no principled distinction between an investment contract and the other interests listed. Since the economic realities test is the minimal test of an investment contract, it should be the minimal test for all securities." Note, *Function over Form: The Sale of Business Doctrine and the Definition of 'Security'*, 63 B.U.L. REV. 1129, 1144-45 (1983). Needless to say, such an interpretation virtually renders the balance of the statutory definition mere surplusage. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2305 (1985).

78. See *supra* note 62.

79. *Id.*

80. Transactional exemptions are those which depend upon the nature of the transaction, rather than the nature of the security, and were included in the 1933 Act to exempt those transactions "[where] there is no practical need for [the Act's] application or where the public benefits

tional exemptions expressly included in the securities laws by Congress, this judicially-fashioned exemption, because it is couched in terms of there being no security, is broader and exempts not only from the registration requirement but also from anti-fraud and other requirements.<sup>81</sup>

But the statute speaks of whether the context requires that the instrument not be considered a security, not whether the context requires an exemption from the securities laws.<sup>82</sup> Unlike the "stock" in *Forman*,<sup>83</sup> corporate stock transferred in a sale of business bears all the "characteristics traditionally associated with stock," and there is nothing in the context of the transaction which controverts that simple fact. The courts cannot, therefore, rely on the preface to the statutory definition to justify their conclusion that corporate common stock is not a security in the context of a sale of business.<sup>84</sup> Whatever the wisdom of the sale of business doctrine, it is founded on a construction of the federal statute which plainly departs from the statutory language. The lower federal courts have thus either not heard or have ignored the Supreme Court's message to pay closer attention to the wording of the statute.<sup>85</sup>

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are too remote." H.R. Rep. No. 85, 73d Cong., 1st Sess. at 5 (1933). See also *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). Examples of transactional exemptions are the intrastate exemption (Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77(c)(a)(11) (1982)), private placement (*Id.* at § 4(2), 15 U.S.C. § 77(d)(2) (1982)), and the brokers' exemption (*Id.* at § 4.(4), 15 U.S.C. § 77(d)(4) (1982)). The statutory exemptions excuse compliance with the registration requirements of section 5 of the 1933 Act, 15 U.S.C. § 77(e) (1982) but do not relieve the participants from the other requirements of the Act. The exemptions in section 4 are expressly limited to "the provisions of section 5," (15 U.S.C. § 77(d) (1982)), and other provisions of the Act specifically include transactions exempted by section 3. See, e.g., §§ 12(2) and 17(c), 15 U.S.C. § 77(q)(c) (1982) and 15 U.S.C. § 77(1)(2) (1982).

81. *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2305 (1985).

82. Even when Congress identified instances where registration was deemed unnecessary, it only exempted them from certain limited requirements and did not exempt from all statutory provisions by excluding those from the definition of security. See *supra* notes 80 and 81.

83. 421 U.S. 837 (1975).

84. In addition, the prefatory clause states, "[u]nless the context otherwise *requires*" (emphasis added). No matter how desirable its proponents find the sale of business doctrine, it is difficult to argue that the context "requires" such an interpretation. See Comment, *A Criticism of the Sale of Business Doctrine*, 71 COLUM. L. REV. 974, 986 (1983).

85. Advocates of the doctrine also take comfort in *Marine Bank v. Weaver*, 455 U.S. 551 (1982). See *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982). In *Marine Bank* the Supreme Court held that a bank certificate of deposit was not a security, in large part because holders of bank certificates of deposit were protected by federal banking laws and regulations. 455 U.S. at 556-59. In another portion of the opinion, a profit sharing agreement was also held not to be a security because it was a unique agreement, not designed to be traded, and afforded the purported investor a degree of control not characteristic of a security. *Id.* at 559-60. To the extent that *Marine Bank* departs from the language of the statutory definition and excludes one of the listed instruments from the definition of security because of its transactional context, it appears that the Supreme Court has ignored its own earlier message and engaged in judicial activism. But see Prentice and

This conclusion was confirmed in recent decisions of the Supreme Court of the United States rejecting the sale of business doctrine. In *Landreth Timber Co. v. Landreth*,<sup>86</sup> the Court refused to apply the doctrine in a transaction where 100% of the corporate stock was transferred. The Court also rejected the doctrine in *Gould v. Rufenacht*,<sup>87</sup> when a 50% controlling interest changed hands. In *Landreth*, while the Court responded to the various arguments in support of the doctrine, the essence of its opinion can be found in one sentence: "The plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts."<sup>88</sup> Although it did not directly accuse the lower courts of ignoring the statute, the patent implication of that statement is that the statute has not been applied as written by those courts adopting the doctrine.

Another recent example of judicial activism is the expansive interpretation of "seller" in section 12(2) of the 1933 Act.<sup>89</sup> That section imposes liability on anyone who "offers or sells" a security by means of any material misstatement or omission.<sup>90</sup> The seller's liability is limited "to the person purchasing such security from him," who may sue for rescission.<sup>91</sup> While 12(2) clearly places liability on the seller of securities,<sup>92</sup> many decisions have broadly extended liability to persons who simply are not sellers of securities.<sup>93</sup>

Roszkowski, *supra* note 72, at 491-95, which argues that *Marine Bank* does not support the rationale of the sale of business doctrine.

86. 105 S. Ct. 2297 (1985).

87. 105 S. Ct. 2308 (1985).

88. 105 S. Ct. at 2303.

89. 15 U.S.C. § 77(1)(2) (1982).

90. *Id.* Sellers can escape liability by proving that they did not know, and in the exercise of reasonable care, could not have known of the material misstatement or omission. *Id.*

91. *Id.* The plaintiff is entitled "to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon. . . ." Alternatively, the plaintiff may collect damages if he no longer owns the security. *Id.*

92. Section 12(2) originally imposed liability on "any person who sells," but the section was amended in 1954 to apply to "any person who offers or sells. . . ." Amendments to Securities Act of 1933, Pub. L. No. 577, § 9, 68 Stat. 686 (1954). The purpose of the amendment was simply to harmonize the language of section 12(2) with the definition of "sell" in section 2(3) and with the registration requirements of section 5. But the intent was that the liabilities under section 12(2) "shall remain unchanged" despite the amendment. H.R. REP. NO. 1542, 83d Cong., 2d Sess. 26 (1954); S. REP. NO. 1036, 83d Cong., 2d Sess. 18 (1954). See generally, Comment, *Attorneys and Participant Liability Under § 12(2) of the Securities Act of 1933*, 1982 ARIZ. ST. L. J. 529, 531, n.12; Note, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361, 363, n.10 (1983).

93. See generally, O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 U.C.L.A. L. REV. 921 (1984).

The usual rationale of these decisions is that liability limited to the plaintiff's immediate seller fails to give effect to the broad remedial purposes of the Securities Act. It is feared that the deterrent to securities fraud will not be fully effective unless all those who are involved in the fraud, not just the one who passes title, are exposed to liability.<sup>94</sup>

Some decisions have advanced the view that anyone who participates in the fraudulent sales transaction should be held liable.<sup>95</sup> Others, feeling that mere participation was too loose a nexus on which to pin liability, have limited liability to those who took part in the actual solicitation of the purchaser.<sup>96</sup> Still others have expanded liability by holding non-sellers secondarily liable under an aiding and abetting theory.<sup>97</sup> But the prevailing view<sup>98</sup> is that section 12(2) imposes liability on all those whose activities were a proximate cause of the plaintiff's purchase of securities.<sup>99</sup>

The proximate cause theory is thought of as a middle ground between the extreme "participation" rationale and the narrow "strict privity"<sup>100</sup> approach.<sup>101</sup> But even the proximate cause theory produces

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94. See, e.g., *Davis v. Avco Financial Services, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 91, 569 (6th Cir. 1984); *In Re Caesars Palace Securities Litigation*, 360 F. Supp. 366 (S.D.N.Y. 1973); *Wonneman v. Stratford Security Co.*, Fed. Sec. L. Rep. (CCH) ¶ 90, 923 (S.D.N.Y. 1959).

95. *Wonneman v. Stratford Security Co.*, Fed. Sec. L. Rep. (CCH) ¶ 90, 923 (S.D.N.Y. 1959); *Zachman v. Erwin*, 186 F.Supp. 681, (S.D. Tex. 1959). This theory is no longer followed. Note, *Seller Liability Under Section 12(2) of the Securities Act of 1933: A Proximate Cause-Substantial Factor Approach Limited by a Duty of Inquiry*, 36 VAND. L. REV. 361, 364 (1983).

96. See, 3 L. LOSS, SECURITIES REGULATION 1713 (2d ed. 1961); Rapp, *Expanded Liability Under Section 12 of the Securities Act: When is a Seller not a Seller?*, 27 CASE W. RES. 445, 450-51 (1977); Schneider, *Section 12 of the Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective*, 51 TENN. L. REV. 235 (1984).

97. See, e.g., *DeBruin v. Andromeda Broadcasting Systems, Inc.*, 465 F. Supp. 1276 (D. Nev. 1979); *Sandusky Land Limited v. Uniplan Groups, Inc.*, 400 F. Supp. 440 (N.D. Ohio 1975); *Lorber v. Beebe*, 407 F. Supp. 279 (S.D.N.Y. 1975); *In Re Caesars Palace Securities Litigation* 360 F. Supp. 336 (S.D.N.Y. 1973).

98. The Eighth Circuit determined to interpret "seller" in a manner that will implement the overall goal of full disclosure. Thus, the key question is whether the defendant "was uniquely positioned to ask relevant questions, acquire material information or disclose his findings." *Wasson v. SEC*, 558 F.2d 879, 886 (8th Cir. 1977). See also *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028 (D. Minn. 1981).

Some courts adhere to the statutory language, and demand strict privity between the plaintiff and defendant as a condition of liability. See, e.g., *Collins v. Signetics Corp.*, 605 F.2d 110 (3d Cir. 1979); *First Trust & Savings Bank v. Fidelity-Philadelphia Trust Co.*, 214 F.2d 320, 324 (3d Cir. 1954); *Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940), cert. denied, 311 U.S. 705 (1940); *McFarland v. Memorix Corp.*, 493 F. Supp. 631 (N.D. Cal. 1980); *Nicewarner v. Bleavins*, 244 F. Supp. 261 (D. Colo. 1965).

99. See, e.g., *Lewis v. Walston & Co.*, 487 F.2d 617 (5th Cir. 1973); *Hill York Corp. v. American International Franchisers, Inc.*, 448 F.2d 680 (5th Cir. 1971); *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964).

100. See *supra* note 98.

results which seem totally unjustified under the statute. Consider, for example, the recent decision in *Davis v. Avco Financial Services Inc.*,<sup>102</sup> where the plaintiffs were duped into investing in Glenn Turner's pyramid scheme known as "Dare To Be Great." The manager of the local office of the defendant finance company attended some of the meetings staged by the promoters, provided potential investors with blank loan application forms, made a speech regarding financing through Avco, and represented to some plaintiffs that "Dare To Be Great" was a good quality investment. Following the proximate cause rationale, the court upheld the finance company's liability under section 12(2).

In this case the finance company clearly was not the seller of the securities at issue. It never owned the securities, it did not pass title to the securities, it received no consideration for the securities, nor was it engaged by the owner. Its involvement was solely to promote its own lending business. Yet in finding that its activities were a "proximate cause" of the investor's losses, the court in *Davis* upheld the finance company's liability as a seller of securities.<sup>103</sup>

That result simply cannot be justified by the language of the statute. The finance company made no offer of sale of an interest in "Dare To Be Great." At most it facilitated the investors' involvement by providing the necessary capital. Its favorable comments on the scheme hardly amounted to an offer or sale. And the statute clearly specifies that the seller "shall be liable to the person purchasing such security from him," who may sue for rescission or, in the event the buyer no longer owns the securities, for damages. Since no one purchased a security from the finance company, rescission is impossible.<sup>104</sup> Thus, the unambiguous language of 12(2) actually precludes the result reached in *Davis*.<sup>105</sup> Perhaps most surprising is that many courts which inter-

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101. *Davis v. Avco Financial Services, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 91, 569 (6th Cir. 1984); *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964).

102. Fed. Sec. L. Rep. (CCH) ¶ 91, 569 (6th Cir. 1984).

103. The same expansive result could be reached under the other theories as well. The finance company representative could easily be held to have participated in the transaction, see *supra* note 95, and to have solicited the investors, see *supra* note 96. Also, if he knew of the violation by the promoter he would have been an aider and abetter due to the substantial assistance he rendered in inducing the investors. See *supra* note 97.

104. See, e.g., *In Re Itel Securities Litigation*, 89 F.R.D. 104, 116 (N.D. Cal. 1981); Comment, *Attorneys and Participant Liability Under Section 12(2) of the Securities Act of 1933*, 1982 ARIZ. ST. L.J. 529, 534. But see *Schneider*, *supra* note 95, at 265.

105. See cases cited *supra* note 98, which require strict privity between buyer and seller as a condition of liability under section 12(2). See also Steinberg, *Section 17(a) of the Securities Act of 1933 after Naftalin and Reddington*, 68 GEO. L. J. 163, 178 (1979).

pret "seller" so expansively evidently realize that they are distorting the statutory language.<sup>106</sup>

## V. IMPLICATIONS OF JUDICIAL ACTIVISM

The foregoing is not intended as an exhaustive list of examples of judicial activism in the interpretation and enforcement of the securities laws. Nor is the identification of any of these examples of judicial activism necessarily original. For the most part other commentators have previously recognized the manner in which statutory language has been ignored or twisted in each instance. But by assembling the examples together a definite pattern of judicial overreaching emerges.

The motivation behind the courts' methodology of broad interpretation is rather transparent. It is not simply a doctrinal attempt to expand the application of the securities laws, since the sale of business doctrine contracts rather than enlarges their scope. Nor can it be dismissed as a populist attempt to extend the protection of the securities laws to those most vulnerable. While the courts were stretching to reach a desired result, protection of sophisticated speculators as well as small investors was guaranteed.<sup>107</sup> The common theme running through all of these examples is the desire to apply the securities laws as the courts deem wise rather than as the laws are written.

Realizing that it makes no difference to the duped investor whether the misleading corporate release was made in connection with a trade, the Court in *Texas Gulf* essentially eliminated the "in connection with" requirement from section 10(b) and Rule 10b-5.<sup>108</sup> Offended that the controlling person would escape liability in an unregistered

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106. In *Davis*, for example, the Court made the following observation: "The courts which have limited 12(2) to literal sellers put great emphasis on the consideration that the securities statutes are indeed *statutes*, and not mere commissions to the federal courts to ride abroad on a great white horse like the Lone Ranger righting all wrongs." Fed. Sec. L. Rep. (CCH) ¶ 91, 569, at 98, 916. Nevertheless, following the proximate cause/substantial factor rationale, liability was imposed on a non-literal "seller" in order to give effect to the far-reaching remedial purposes of the law.

And in *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964), which also expanded section 12(2) by use of the proximate cause theory, the court's awareness that it was deviating from the statutory language is apparent from the following: "Perhaps one problem is the nature of the relief sought-rescission: it would seem natural to hold only the actual party to the contract to provide such relief. On the other hand, the spirit of the Acts would be defeated if such a narrow view would be adopted." *Id.* at 64.

107. "The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

108. See *supra* notes 12-19 and accompanying text.

secondary distribution, the Court in *Wolfson* ignored the long-established meaning of section 4(1) to avoid that result.<sup>109</sup> Believing that exemptions should be limited to instances where the benefits of regulation are unnecessary, the Court in *Ralston Purina* interpreted "private" in a way unsuggested by its common definition.<sup>110</sup> Feeling that the securities laws need not apply to a sale of business even when accomplished by a transfer of stock, the courts applying the sale of business doctrine rewrote the statutory definition of "security."<sup>111</sup> And, afraid that the liabilities imposed on "sellers" by section 12(2) will not sufficiently deter securities fraud, the courts have unapologetically expanded that liability to non-sellers.<sup>112</sup>

Each of these is an example of judicial legislation. The courts have made value judgments, sometimes aided by the legislative history of the securities laws but often based solely upon their predilections, about what the law ought to be. When the congressional enactments do not comport with the courts' views, the courts simply rationalize a departure from the statutory language. Thus, the courts have effectively rewritten the statutes.

Aside from the potential constitutional question of whether the courts have impermissibly exceeded their role within the constitutional system of separation of powers,<sup>113</sup> practical difficulties arise when the courts choose to legislate. Consistency is sacrificed. The specific content of the securities laws will depend upon the jurist resolving each controversy and his or her personal preferences. Individual provisions of the securities statutes will take on entirely different meanings in different courtrooms. Certainty and predictability are the victims of such a regulatory scheme based upon men and not upon laws. Those planning and structuring their affairs, in attempting to comply with the securities laws, have no assurance that the language and precedential interpretations of the statutes will control. The result is a chaotic, unreliable regulatory structure.

Such a regulatory scheme produces many undesirable results. First, it is grossly unfair to those who must operate under the regulations. When an individual is not told until the completion of his activity whether his conduct conformed to the subsequently determined requirements of the regulation, obvious and legitimate questions about the

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109. See *supra* notes 20-30 and accompanying text.

110. See *supra* notes 31-42 and accompanying text.

111. See *supra* notes 61-88 and accompanying text.

112. See *supra* notes 89-106 and accompanying text.

113. See generally Kurland, *Government by Judiciary*, 2 UALR L.J. 307 (1979).



fairness of the regulation are raised. Second, an unreliable and unpredictable regulation is not likely to promote the conduct sought. If the meaning of the regulation must await an after-the-fact judicial interpretation, people cannot be expected to know in advance what is required of them. In fact, this type of regulation could be counterproductive if it encourages those who do not wish to comply to engage in unacceptable conduct in the hope that, when challenged, the court will redefine the regulation. Third, regulations which cannot be understood and whose purpose therefore remains unclear, undermine the public's confidence in their validity and efficacy. Compliance with regulations which, despite the presence of penalties is often more voluntary than coerced, will diminish as trust in the consistency of their enforcement decreases.

A certain degree of flexibility is necessary in statutory construction to allow the law to adapt to new and unanticipated events. Statutory principles must maintain a continuing relevance to an evolving society and should not be rigidly confined to the precise set of circumstances anticipated by the legislature when the law was first adopted. The courts, therefore, must be allowed some latitude to conform statutory wording to legislative intent. "Dictionary judging"<sup>114</sup> should not be re-

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114. Judge Learned Hand characterized the theory that judges must slavishly follow the letter of the law as the "dictionary school." L. Hand, *How Far is a Judge Free in Rendering a Decision?* Reprinted in Irving Dillard, *The Spirit of Liberty: Papers and Addresses of Learned Hand* (Knopf 1952) 103, 107. Judge Hand rejected both the extremist "dictionary school" and its equally extreme counterpart which would allow jurists almost complete latitude in reaching decisions. The former would frustrate legislative intent, as a literal application of the statute to unforeseen circumstances could produce unintended results, and the latter would result in an undemocratic frustration of majority will, as the judge replaces legislative enactments with his own preferences. Judge Hand advocated a middle ground. *Id.*

As applied to the instant concerns, it seems the judges have overstepped the bounds set by Judge Hand. For example, in creating a broad new exemption for sales of businesses and in expanding section 12(2) liability to non-sellers, there is no assurance that Congress would have reached the same conclusion (it can, of course, be argued that Congress reached the opposite conclusions). Unlike the straightforward examples cited by Judge Hand justifying departure from the strict statutory language (e.g., and anti-street fighting statute which prohibits drawing blood on the street would not be applied against a surgeon who bled a man in emergency treatment), in the examples cited in this article Congress could easily choose different alternatives (and ones perfectly consistent with the purposes of the statute) from the ones selected by the courts. Even though the court may be justified in some circumstances in exercising independence from the strict statutory language when necessary to avoid clearly unintended results, Judge Hand observed:

But the judge must always remember that he should go no further than he is sure the government would have gone, had it been faced with the case before him. If he is in doubt, he must stop, for he cannot tell that the conflicting interests in the society for which he speaks would have come to a just result, even though he is sure that he knows what the just result should be. He is not to substitute even his justor will for theirs; otherwise it would not be the common will which prevails, and to that extent the people

quired. But the examples of interpretation of the securities laws discussed earlier go far beyond simply adapting the law to modern issues. The courts have rewritten the securities laws, usually in ways unsupported by the legislative history, and often in a manner which is unsupported by the statutory language.

### CONCLUSION

The dangers posed by judicial revision of the securities laws cannot be overstated. Perhaps no provision in the securities laws is more basic to the regulatory scheme than the definition of "security" itself. If that definition is not immune from an overly-ambitious judicial rewrite, which effectively transforms not only the words of the statute but their meaning as well (and the sale of business doctrine demonstrates that it is not so immune), then all provisions of the securities laws are vulnerable. No matter how unambiguous its language or precise its intent, any provision of the securities laws is susceptible to being rewritten by the judges who rewrote the basic statutory definition.

In order to guarantee a more reliable and predictable, and therefore more effective regulation, the courts should do as the Supreme Court has commanded. They should pay closer attention to the language of the statutes and less attention to whether the results produced by the statutes are those which the judges think most wise.

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would not govern.

*Id.*

