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SECURITIES

OVERVIEW

During the past survey period, the Tenth Circuit Court of Appeals issued two opinions in the securities area involving controversial theories of recovery which have divided the circuits.[1] In *Christy v. Cambron*,[2] the court relaxed the criteria of the sale of business doctrine to encompass a transfer of less than a 100% interest in a business to four purchasers in varying proportions. The court found that the stock shares issued were only indicia of ownership and not "securities" subject to the regulations of the 1933 Act[3] and the 1934 Act[4] and its corresponding rules.[5] In *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*,[6] the Tenth Circuit recognized the fraud on the market theory of liability for the first time, adopting perhaps the most expansive view of any circuit. This theory allows plaintiffs to rely on the integrity of the trading market and does not require them to prove actual reliance on a specific fraudulent act to establish causation in a 10b-5 action.

This article compares the positions of the Tenth Circuit to other jurisdictions on both the sale of business doctrine and the fraud on the market theory of liability. First, the article explores the early cases and their supporting rationales. Second, it analyzes and compares the conflicting lines of cases in both areas. Third, it discusses the application of precedent by the Tenth Circuit in *Christy* and *Raney*. Finally, it suggests possible ramifications of these decisions.

1. In an unpublished opinion, SEC v. Blinder, Robinson & Co., No. 82-1954 (10th Cir. Sept. 19, 1983), *cert. denied*, 105 S. Ct. 783 (1985), the Tenth Circuit affirmed the Federal District Court of Colorado's granting of an injunction against the defendants for violations of securities regulations. The defendant, the best efforts underwriter on an all or nothing offering of shares and warrants of a start-up corporation, engaged in several large transactions for its own account when it appeared that the entire offering would not be sold by the deadline. Since these transactions did not qualify as bona fide purchases, the continuation of distribution by the defendant from its own account subsequent to the closing date was a violation of Rule 10b-6(c)(3), 17 C.F.R. § 6240.10b-6(c)(3) (1984). Because the all or nothing offering failed to close, the defendant was obligated to make refunds. This was not done and Rule 10b-9, 17 C.F.R. § 240.10b-9 (1984), was violated. Also, the escrow account was improperly managed because funds were disbursed prior to the closing of the offering. This was a violation of Rule 15c-4, 17 C.F.R. § 240.15c-4 (1984). The appellate court also found the defendants' argument that aider and abettor liability was not a component of securities regulation unpersuasive. Finally, the evidence of manipulations and non-disclosures supported the trial court's determination that the defendant had violated the anti-fraud provisions of the 1933 Act, § 17(a), 15 U.S.C. § 77q(a) (1982), the 1934 Act, section 10(b), 15 U.S.C. § 78j(b) (1982), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984).

2. 710 F.2d 669 (10th Cir. 1983).

3. The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1982).

4. The Securities Exchange Commission Act of 1934, 15 U.S.C. §§ 78a-78kk (1982).

5. 17 C.F.R. §§ 240.0-1 to .31-1 (1983).

6. 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 104 S. Ct. 1285 (1984).

I. EXPANDING THE SCOPE OF THE SALE OF BUSINESS DOCTRINE

A. Christy v. Cambron

In *Christy v. Cambron*,[7] plaintiffs Kelly Christy, Hunt Klein, Richard Loose, and Pearse Nolan each made capital contributions to a new corporation, Mark Cambron, Inc., which was formed by the defendant, Mark Cambron, to build and own a discotheque in Vail, Colorado. Each plaintiff became a director and officer of the corporation[8] and received shares reflecting his or her contribution to the start-up capital fund. The plaintiffs' capital contributions totalled $97,160, but the preparation costs for opening the disco were only approximately $50,000. Pursuant to the pre-incorporation agreements signed by plaintiffs, Cambron received the balance remaining in the start-up fund after preparation expenditures, about $40,000, as compensation.[9]

Due to insufficient financing and poor economic conditions in Vail,[10] the disco operated for less than three months. Shortly after it closed, it was sold to a third party who eventually defaulted on the payments. Cambron and plaintiffs repossessed the property and listed it with a realtor, Trevor T. Bradway Company. Defendant Ernest Crates purchased the disco through a Bradway agent with the intention of immediately reselling it for a profit. Because of the poor economic conditions in Vail, Crates was unable to resell and sustained a loss.

Plaintiffs filed suit in the Federal District Court of Colorado alleging that Cambron violated rule 10b-5 of the Securities and Exchange Commission,[11] and Section 12(2) of the Securities Act of 1933.[12] They further contended that Cambron breached his fiduciary duty as an incorporator under Colorado law. Crates counterclaimed against plaintiffs and cross-claimed against Cambron alleging fraud in the sale of Mark Cambron, Inc. stock to him and violation of securities laws and regulations. Crates also cross-claimed against Cambron for breach of fiduciary duty. A third party claim by Crates against Trevor T. Bradway Company settled prior to trial.

The jury returned verdicts for plaintiffs against Cambron on their three claims for relief and awarded compensatory and punitive damages. Crates received verdicts against all plaintiffs and Cambron. Plaintiffs and Cambron filed motions for new trial and judgment notwithstanding the verdict. Crates moved for a new trial on the issue of damages only. The court granted Cambron's motion for a judgment notwithstanding the verdict and dismissed the case in its entirety.[13] Plaintiffs appealed to

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7. 710 F.2d 669 (10th Cir. 1983).

8. The court noted that "[p]laintiffs were involved in running the disco . . . ." *Id.* at 671. *See infra* text accompanying notes 46-47.

9. 710 F.2d at 671.

10. During the winter ski season of 1975-76, the Vail area experienced inadequate snowfall and a fatal gondola mishap, causing adverse national publicity.

11. 17 C.F.R. § 240.10b-5 (1984).

12. 15 U.S.C. § 771 (1982).

13. "Reasons given by the trial court . . . were that . . . (1) the dispute did not involve a "security" . . .; (2) there was no causal relationship between the plaintiffs' losses

the Tenth Circuit contending that the trial court erred in granting that motion. The Tenth Circuit affirmed the lower court's decision to dismiss the case.[14]

B. *Defining a "Security"*

The circuits are divided on whether shares of corporate stock transferred as part of a sale of a business qualify as "securities" within the meaning of the Securities Acts.[15] Some jurisdictions evaluate all stock according to its character and do not distinguish among the various contexts in which shares of stock can be transferred.[16] Other jurisdictions follow a transactional approach and classify stock transferred in the sale of a business as merely the medium of exchange through which the business assets are purchased.[17] In these circuits, these shares of stock are

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and any misrepresentations or omissions by Cambron; and (3) Crates' claims were not supported by the evidence." 710 F.2d at 672.

14. In considering a motion for judgment notwithstanding the verdict, trial courts analyze evidence "in a light most favorable to the plaintiff." *Id.* at 671. Specifically, the court stated that the motion could "not be granted unless the evidence is susceptible of no reasonable inferences that sustain the position of the party against whom the motion is made with respect to one or more of the necessary elements of each claim . . . ." (citations omitted). *Id.* at 672.

15. Section 2 of the 1933 Act, 15 U.S.C. § 77b(1) (1982) states:

> [U]nless the context otherwise requires—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 or 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.

Section 3 of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982) states:

> [U]nless the context otherwise requires—The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, 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 in 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 instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill or exchange, or banker's acceptance which has a maturity date at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

While the definitions in the 1933 Act and the 1934 Act are not identical, they were intended to reflect substantially the same meaning and have been so construed by the courts. S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934), *cited in* Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983), *affirmed on reh'g*, 730 F.2d 1403 (11th Cir. 1984) (en banc); *see also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336, 342 (1967).

16. *See infra* notes 20-21 and accompanying text.

17. *See infra* notes 22-35 and accompanying text.

not "securities," they are only indicia of ownership of the business assets, and, consequently, the transfer of stock does not receive the protection of securities regulations.[18] These opposing philosophies are supported by conflicting interpretations of the same Supreme Court case, *United Housing Foundation, Inc. v. Forman.*[19]

The Second, Third, Fourth, Fifth, and Eighth Circuits focus on the character of the instrument transferred and disregard the nature of the underlying transaction.[20] They interpret part II.A. of the *Forman* opinion as providing securities regulation coverage to any instruments which have the characteristics of stock. These attributes include recognition as stock for the purposes of corporate, commercial, and tax law; the opportunity of holders to receive dividends, to vote, and to realize appreciation in value upon sale; and the capacity to transfer to others or to pledge.[21] This approach adopts a literal application of the definition of "securities." Only if the instruments lack the traditional characteristics of stock will these courts apply the "economic realities" analysis from part II.B. of the *Forman* opinion.

The Seventh, Ninth, Tenth, and Eleventh Circuits follow the "economic realities" approach, set forth in part II.B. of *Forman*, which advocates a flexible interpretation of the security definition.[22] Under this

18. *Id.*

19. 421 U.S. 837 (1975).

20. Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir.) (plaintiff purchased 50% of corporation's outstanding stock from defendant, the sole shareholder, and as consideration promised to pay a specified sum and devote certain efforts to the business.), *cert. granted,* 105 S. Ct. 428 (1984); Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983) (three plaintiffs purchased all the outstanding shares of a corporation from the two defendants and assumed managerial control of the business.); Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227 (2d Cir. 1982) (Seagrave Corp., a closely-held family corporation, purchased from Vista Resources, Inc. all the assets of 29 of its subsidiary corporations including real property, machinery, equipment, and stock which was listed on the New York Stock Exchange.), *rev'g* 534 F. Supp. 378 (S.D.N.Y. 1982), *cert. granted,* 104 S. Ct. 2341, *cert. dismissed,* 105 S. Ct. 23 (1984); Cole v. PPG Indus., Inc., 680 F.2d 549 (8th Cir. 1982) (rejecting the sale of business doctrine on a claim filed under the Arkansas Securities Statutes relying on *Forman.*); Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982) (plaintiffs purchased 100% of the outstanding stock of an existing corporation from defendant, its sole shareholder.); Glick v. Campagna, 613 F.2d 31 (3d Cir. 1979) (plaintiff sold his entire 50% interest of a corporation to defendant, who owned the other 50% interest.); Coffin v. Polishing Mach., Inc., 596 F.2d 1202 (4th Cir.), *cert. denied,* 444 U.S. 868 (1979) (discussed *infra* at text accompanying notes 43-44).

21. Seagrave Corp., 696 F.2d at 229.

22. Landreth Timber Co. v. Landreth, 731 F.2d 1348 (9th Cir.) (plaintiffs purchased 100% of corporation's outstanding stock and retained seller as an advisory consultant for one year.), *cert. granted,* 105 S. Ct. 427 (1984); Chandler v. KEW, Inc., 691 F.2d 443 (10th Cir. 1977) (discussed in the text accompanying note 42); Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982) (created the rebuttable presumption that if the purchaser already has, or by the purchase in question acquires, more than 50% of the common stock of the corporation, his purpose in purchasing the stock will be presumed to have been entrepreneurship rather than investment; thus, the sale of business doctrine is recognized.); King v. Winkler, 673 F.2d 342 (11th Cir. 1982) (discussed in the text accompanying notes 38-41); Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.) (discussed in the text accompanying note 40), *cert. denied,* 451 U.S. 1017 (1981); *see* 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).

approach, a transaction evidenced by the sale of "stock" is not necessarily a security transaction even though the statutory definition of security includes the words "any . . . stock."[23] This analysis focuses on the substance and purpose of the transaction and de-emphasizes its form and label.[24] The circuits following this analysis do not regard fulfillment of the part II.A. stock attribute requirements of *Forman* as conclusive. They also apply the three-part *Howey-Forman* "economic realities" test[25] to determine if the transaction evidenced by a transfer of stock is governed by the federal securities regulations. The elements of this analysis are: (1) an investment, (2) in a common venture, (3) with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[26] These courts interpret *Forman* to require satisfaction of the part II.B. requirements in order to classify an exchange or transfer as a securities transaction.

The first element, presence of an investment, is fulfilled if the investor commits "his assets to an enterprise or venture in such a manner as to subject himself to a financial loss."[27] To qualify as an investment, the investor must give up a tangible and definable consideration. In return, he receives a separate financial interest that has, substantially, the characteristics of a security.[28]

The second element, a common enterprise, has been defined as "one in which the fortunes of the investor are interwoven with and dependant upon the efforts and success of those seeking the investments of third parties."[29]

Some courts analyze the third element in two parts: (1) was there a reasonable expectation of profit? and (2) was this profit to be derived from the managerial and entrepreneurial efforts of others? It is the second part of this element that was determinative in most cases.[30] This second component previously required profits to be derived "solely" from the efforts of others.[31] The courts no longer construe the term "solely" literally; instead, they examine the quality and quantity of the

23. United Housing Found., Inc. v. Forman, 421 U.S. at 848; 45 SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946); *see also* Tcherepnin v. Knight, 389 U.S. at 336.

24. *Forman*, 421 U.S. at 848 (citing *Tcherepnin*, 389 U.S. at 336).

25. *Howey* extended coverage of the federal securities laws by creating a three-part analysis to define an "investment contract." Thirty years later, *Forman*, in limiting protection of the federal laws, adopted a modified version of the *Howey* test and labelled it the "economic realities" approach.

26. *Forman*, 421 U.S. at 852; *Howey*, 328 U.S. at 301; Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1039 (10th Cir. 1980).

27. Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976); Wooldridge Homes, Inc. v. Bronze Tree, Inc., 558 F. Supp. 1085, 1086 (D. Colo. 1983); SEC v. International Mining Exch., Inc., 515 F. Supp. 1062, 1067 (D. Colo. 1981).

28. International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979) (the court found that employees' contributions to a noncontributory, compulsory pension fund did not constitute an investment.)

29. SEC v. Glenn Turner Enter., 474 F.2d 476, 482 n.7 (9th Cir.) (citing Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162, 172 (9th Cir.), *cert. denied*, 366 U.S. 919 (1961)), *cert. denied*, 414 U.S. 821 (1973).

30. *See* Thompson, *supra* note 22, at 238-39.

31. *Howey*, 328 U.S. at 299.

efforts performed by both parties.[32] The Tenth Circuit has adopted the following interpretive test: "whether the efforts made by those other than the investor are undeniably significant ones, those essential efforts which affect the failure or success of the enterprise."[33] Contribution of time and effort are not the only factors examined. The focus is on the degree of ultimate control over the operations of the business.[34] Therefore, the reliance of the investor on the promoter or third parties does not have to be complete, as long as the duties performed by the investor are nominal or limited and have an inconsequential impact in the success of the enterprise.[35]

C. *Rationalizing the Facts with the Law*

Typically, the sale of business doctrine has been applied to transactions where the investor acquired 100% of the outstanding stock and assumed control of the corporation.[36] This transaction is classified as the sale of a business through the sale of stock. The substance of the transaction is the purchase of a business and the stock is regarded as the medium of exchange and merely an indicia of ownership. In *Christy*, plaintiffs collectively acquired an eighty-one percent interest in Mark Cambron, Inc., each holding various numbers of shares proportionate to their investment, and defendant Cambron continued to serve as the organizer and promoter of the corporation. The court chose to extend the sale of business doctrine to this situation, finding that plaintiffs did not expect profits based on Cambron's efforts.[37] The court, however, failed to adequately address the issue of control, raising the question of the extent to which an investor or purchaser can be involved in management without invoking the doctrine.

In a footnote, the court cited *King v. Winkler*,[38] an Eleventh Circuit opinion, for the proposition that "[a] sale of less than 100% of the stock

32. *Turner*, 474 F.2d at 482.

33. *Aldrich*, 627 F.2d at 1040 n.3 (quoting *Turner*, 474 F.2d at 482).

34. Crowley v. Montgomery Ward & Co., 570 F.2d 877, 880 (10th Cir. 1978).

35. Commander's Palace Park Ass'n v. Girard & Pastel Corp., 572 F.2d 1084, 1086 (5th Cir. 1978); Schultz v. Dain Corp., 568 F.2d 612, 615 (8th Cir. 1978); Fargo Partners v. Dain Corp., 540 F.2d 912, 915 (8th Cir. 1976); McCown v. Heidler, 527 F.2d 204, 211 (10th Cir. 1975); Lino v. City Inv. Co., 487 F.2d 689, 692 (3d Cir. 1973) (quoting SEC Act Release No. 5211 (November 30, 1971), reported in [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78446 at page 80,973).

36. Until the decision in Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982), all circuit court cases applying the sale of business doctrine involved a transfer of 100% of the corporation's outstanding stock. In *Sutter*, the Seventh Circuit created an investor-entrepreneur distinction and established a rebuttable presumption that one holding 50% or more of a corporation's stock is an entrepreneur and the sale of the business doctrine applies to a transfer of this interest. The Tenth Circuit has joined this minority view but failed to discuss *Sutter*, possibly because none of the interests transferred equalled a 50% share by itself.

37. After examining the evidence, the court concluded that while the venture included potentially fraudulent elements, these elements failed to develop into a legally actionable claim. Thus, the court could have denied recovery for the plaintiffs because no fraud existed without expanding the sale of business doctrine to include the unique factual elements of *Christy*.

38. 673 F.2d 342 (11th Cir. 1982).

might not be covered by the [Securities] Acts. A sale of 100% of the stock can be covered by the Acts."[39] *King* involved the transfer of an existing business through the private sale of the sole shareholder's entire interest in the corporate stock to two purchasers who intended to manage and operate the business. The passage quoted from *King* continues, stating that "[t]he number of sellers and purchasers will not necessarily control the outcome."[40] While the *King* court stated that the approach used to resolve the case was not a "function of numbers,"[41] the facts in *King* resemble the classic sale of business doctrine case. The purpose of the transaction in *King* was to sell all of the business assets. There were no numbers with which the court had to struggle. The sole shareholder sold his entire interest and completely relinquished control over the business assets and the purchasers assumed complete control of the business and its success or failure depended on their efforts alone. The statement quoted in the *Christy* opinion does not reflect the true precedential value of *King*.

The *Christy* court cited *Chandler v. KEW, Inc.*[42] as the authority for classifying *Christy* as a sale of business doctrine case. *Chandler*, although published five years after it was decided, was the first post-*Forman* appellate court recognition of the sale of business doctrine. It involved the sale of a liquor store where the purchaser received 100% of the stock in the transfer and assumed control of the business. *Chandler* is the precedent for the sale of business doctrine in the Tenth Circuit, but unlike *Christy*, it represents the typical, classic sale of business doctrine case. The *Christy* court failed to distinguish a more analogous Fourth Circuit case, *Coffin v. Polishing Machines, Inc.*[43]

Polishing Machines, Inc. was interested in obtaining financing to expand its business. This objective was accomplished by selling fifty percent of its outstanding stock to Coffin, who became its executive vice-president. The Fourth Circuit characterized the transaction as "the very sort of transfer with which the federal securities laws are most concerned, 'the sale of securities to raise capital for profit-making purposes.' "[44] The Fourth Circuit declined to apply the economic realities test and, instead, held that because the shares purchased by Coffin were ordinary corporate stock, the transaction was subject to the federal securities laws.

By way of contrast, in *Frederiksen v. Poloway*,[45] the Seventh Circuit applied the sale of business doctrine to the transfer of an existing business through the purchase of 100% of its outstanding stock. The court distinguished the *Coffin* decision on two grounds. First, *Coffin* did not

39. *Id.* at 346.
40. *Id.*
41. *Id.*
42. 691 F.2d 443 (10th Cir. 1977) (initially published at [1979 Transfer Binder] FED. SEC. LAW REP. (CCH) ¶ 96,966 (10th Cir. 1977) at page 96,053).
43. 596 F.2d 1202 (4th Cir. 1979).
44. *Id.* at 1204; *see also Forman*, 421 U.S. at 849.
45. 637 F.2d 1147 (7th Cir. 1981).

involve the transfer of 100% of the stock. Second, the *Frederiksen* court determined that the purpose of the *Coffin* transaction had not been to vest ownership of the business in the purchaser despite the fact that the investor assumed the duties of executive vice-president. It found that the economic reality of the *Coffin* transaction was the sale of stock to raise capital to finance corporate expansion. It is not apparent from the *Frederiksen* opinion how the Seventh Circuit would resolve cases similar to *Coffin*, but its analysis demonstrates an awareness for distinguishing facts and a concern for establishing possible parameters of the doctrine.

The analysis in *Christy* is not nearly as revealing. Given the mechanical application of the *Howey-Forman* test, the outcome of this case is predictable. The court conclusively stated that "[t]he economic realities . . . show that plaintiffs were buying a discotheque, and there is no question about that."[46] The economic realities approach, however, promotes substance over form, and requires careful application of the test's three elements to the facts. Unfortunately, the court's rationale in *Christy* does not include a discussion of the purpose of the transaction or the extent of control retained by the plaintiffs over their investment and its relation to their respective shares.

Cambron was seeking financial backing to build a discotheque. He offered interests in his corporation, denominated in shares of stock, in exchange for capital contributions needed to finance the discotheque. It appears Cambron's motive for selling interests in his corporation was to raise capital to build a discotheque and generate profits for himself and the investors. When the plaintiffs made their investment in Mark Cambron, Inc., the disco was only in the organizational stages and not yet operational. It does not appear as obvious and conclusive as the court indicated that plaintiffs were purchasing the discotheque. Indeed, the opposite appears to be the more reasonable conclusion.

The court determined that the controlling issue was "not a matter of numbers, but, rather, whether the purchaser of securities expects to profit from the efforts of others."[47] This interpretation indicates that in the Tenth Circuit, the determinative factor in a sale of business transaction is whether the investor exercises control over the interest acquired, and not the medium through which the transaction was accomplished or the underlying purpose of the transfer. In electing to focus on the control component, the Tenth Circuit has created a distinction between passive investors and those who choose to assume even a nominally active role in controlling their newly acquired interest.

In reaching its holding, the court implies that the control exercised by the four investors was more than nominal or limited and their efforts were determinative to the success or failure of the enterprise. The plaintiffs' only actions involved acquiescing to leasing rather than purchasing the disco equipment and the firing of a group of employees by plaintiff Klein. No executive responsibilities or actions were offered

46. *Christy*, 710 F.2d at 672.
47. *Id.* at n.1.

to support the control factor. Moreover, the opinion indicates that the minimal involvement of plaintiffs came in response to their after-the-fact realization that the enterprise was undercapitalized. At the time Cambron sold plaintiffs their interests, they had no intention of providing anything other than capital.

The "efforts of others" requirement is an integral part of the economic realities analysis and frequently operates to distinguish sale of business transfers from securities transactions. It should not, however, be considered determinative in every instance. The *Christy* court regards the "efforts of others" element as conclusive and narrowly construes it to require complete passivity on the part of the investor and exclusive reliance on the efforts of third parties, even when financial demise becomes probable. This interpretation expands the sale of business doctrine beyond its original purpose and denies securities law coverage to generally passive investors in enterprises managed primarily by promoters.

II. The Fraud on the Market Theory of Liability in 10b-5 Actions

A. T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority

In *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Authority*,[48] the Tenth Circuit considered the propriety of plaintiffs' claim as a class action in an interlocutory appeal.[49] The complaint filed by the plaintiff, T.J. Raney & Sons, Inc., a distributor of the Series C Bonds of the Fort Cobb, Oklahoma Irrigation Fuel Authority, alleged securities fraud under Rule 10b-5[50] based on a form of the fraud on the market theory. Raney claimed that the defendant bond counsel recklessly affirmed the validity of the bonds and concealed the wrongful divergence of the proceeds. It contended that the bond proceeds were commingled with other funds and never used for their intended purpose. Raney also claimed that the bonds were unlawfully issued under Oklahoma law. The Series C Bonds went into default and this class action ensued.

Raney sought to represent all Series C bondholders. There were approximately sixty Series C bondholders with different degrees of investment experience. All the purchasers did not receive the same infor-

48. 717 F.2d 1330 (10th Cir. 1983).

49. In West v. Capital Fed. Sav. & Loan Ass'n, 558 F.2d 977 (10th Cir. 1977), the court explained the basis for the "Death Knell" exception of 28 U.S.C. § 1291 (1982) which grants the court of appeals jurisdiction over the final decisions of the district courts. To appeal a decertification order, plaintiffs must prove that the suit will not continue as a private action if the class action is decertified.

In Bowe v. First of Denver Mortgage Investors, 562 F.2d 640 (10th Cir. 1977), the court discussed the preferable means for review of class action orders under 28 U.S.C. § 1292(b) (1982) or through an extraordinary writ of mandamus. To qualify under § 1292(b), the order must involve a controlling question of law which "may materially advance the ultimate termination of the litigation." *Id.* at 644 n.1. The jurisdiction of the court of appeals in this situation is discretionary.

50. 19 C.F.R. § 240.10b-5 (1983); *see infra* note 85 (text of Rule 10b-5).

mation. Some received an allegedly fraudulent offering circular and bond opinion before purchasing while others did not.

Defendants contended in their motion to decertify the class action that this case was inappropriate as a class action because not all the class members relied on the offering circular and the bond opinion. They asserted that because causation could not be established with respect to each class member, the claim as a class action must fail. They also claimed that Raney was not a suitable class representative. It was a case of first impression in the Tenth Circuit.[51]

The Tenth Circuit affirmed the trial court's denial of the motion to decertify and recognized the plaintiffs' cause of action under a variation of the fraud on the market theory of liability created in *Shores v. Sklar*[52] which allowed investors to assume that any securities offered for sale were "entitled to be marketed."[53] The court noted that three other circuits, the Second, Fifth, and Ninth, had adopted various forms of the fraud on the market theory of liability for 10b-5 actions and elected to join this trend with the *Raney* case.[54]

B. *The Reliance Requirement in 10b-5 Actions*

The traditional measure for causation in a private action under SEC Rule 10b-5 is the plaintiff's actual reliance on the defendant's misrepresentations.[55] In a misrepresentation case, the plaintiff must affirmatively allege and prove that he relied on false representations made by the defendant. The reliance requirement is fulfilled if "the misrepresentation is a substantial factor in determining the course of conduct which results in [the investors'] loss."[56] In nondisclosure or omission cases, this standard requires the plaintiff to show he relied to his detriment on factors which were not revealed to him. Because this burden of proof was difficult to sustain, the Supreme Court established a presumption of reliance in favor of the plaintiff which arises after the plaintiff establishes the materiality of the undisclosed facts.[57] Materiality is established by

51. 717 F.2d at 1333.

52. 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983).

53. *Id.* at 471.

54. 717 F.2d at 1332 (citing Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981) (discussed *infra* at text accompanying notes 71-76); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (discussed *infra* at text accompanying notes 80-87); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975) (discussed *infra* at text accompanying notes 60-68)).

55. The elements of a classic 10b-5 violation are: (1) a false representation made by defendant; (2) with defendant's scienter; (3) the false representation is material; (4) plaintiff justifiably relied on the false representation; (5) plaintiff purchased or sold securities in connection with the false representation; and (6) plaintiff was damaged as a result of the false representation. Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976) (en banc), *cert. denied*, 430 U.S. 955 (1977). *See generally* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

56. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102 (10th Cir.) (bracketed information in the original) (quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.) (quoting Restatement of Torts § 546 (1938)), *cert. denied*, 382 U.S. 811 (1965)), *cert. denied*, 404 U.S. 2004 (1971).

57. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

proving that a reasonable man might have considered the undisclosed facts important in making his decision.[58] The presumption of causation is not conclusive; it merely shifts the burden of proof of non-reliance to the defendant. The defendant meets his burden by showing that the plaintiff's investment decision would not have been different even if the defendant had disclosed the omitted facts.[59]

Proving reliance is equally difficult where the alleged fraud has affected the market and consequently injured the plaintiff. The fraud on the market theory recognizes that investors make their decisions based on a variety of factors, some unrelated to specific statements made to investors about the investment, including the securities' presence in a reliable market. A literal interpretation of the reliance element would compel the plaintiff to prove reliance on specific actions or false representations of the defrauder rather than the effects of such actions or representations on the market. Those circuits which recognize the fraud on the market theory of liability do not require proof of direct reliance on a particular false representation to sustain a 10b-5 claim. A presumption of reliance on the integrity of the market arises when the plaintiff establishes the materiality of the false representations, and the burden of proof shifts to the defendant to prove non-reliance by plaintiff upon the market or non-materiality of the false representations.

C. *The Fraud on the Market Theory of Liability*

The leading case addressing the fraud on the market theory is *Blackie v. Barrack*.[60] In *Blackie*, the plaintiffs, stock purchasers in the secondary market, filed a class action suit claiming that the defendant corporation issued false annual and interim reports, press releases, and SEC filings as to its financial condition which affected the price they paid for the shares. The Ninth Circuit, in effect, extended the presumption of reliance created by the Supreme Court, in *Affiliated Ute Citizens of Utah v. United States*,[61] for nondisclosure actions to cases involving misrepresentations that inflate the price of stock traded on the open market.[62] It is not necessary to show direct reliance to establish causation in this context. Causation is established by showing that plaintiffs purchased stock in the secondary market and that the misrepresentations which distorted the stock's value were material.[63] The burden then shifts to the defendant to disprove causation by disproving materiality; by showing that even though the false representation was material, a nominal number of traders relied on it; or by showing that the purchaser acted without

58. *Id.* at 154.
59. *Id.* at 153-54.
60. 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).
61. 406 U.S. 128 (1972).
62. 524 F.2d at 906 n.22. The court declined to interpret *Affiliated Ute* as creating a presumption of reliance in 10b-5 actions. Instead, it viewed reliance based upon materiality as a threshhold of causation.
63. *Id.* at 906. "[C]ausation is adequately established in the impersonal stock exchange context by proof of purchase and of materiality of misrepresentation, without direct proof of reliance." *Id.*

knowledge of the false character of the representation, or that he would have acted in the same manner had he known of it.[64] The court's rationale was that an investor relies generally on the market to reflect valid stock prices, and thus indirectly on the truth of the representations underlying the stock price.[65] The court reasoned that to require proof of direct reliance would defeat claims where reliance is indirect, even though the misrepresentations were material and causation was established.[66] The extension of the *Affiliated Ute* presumption in this case alleviated the "unreasonable and irrelevant evidentiary burden"[67] of the traditional reliance requirement. The court believed this holding would facilitate enforcement of securities laws and encourage complete recoveries by plaintiffs with valid claims.[68]

The Ninth Circuit expanded the fraud on the market theory beyond reliance on the integrity of the market to reflect accurate stock values in *Arthur Young & Co. v. United States District Court*.[69] Here, plaintiffs alleged that false and misleading registration statements and prospectuses filed with the SEC were sent or shown to every investor who relied on them to his detriment in the purchase of limited partnership interests promoted by the defendant. There were 1215 investors represented in this class action. The court determined that plaintiffs were entitled to rely on the integrity of the regulatory process to produce truthful filing statements.[70]

In *Panzirer v. Wolf*,[71] the Second Circuit found that the plaintiff stated a cognizable fraud on the market claim based on her reliance on the integrity of the market in producing the information reported in the *Wall Street Journal*. She established a chain of causation by alleging that if the corporation's annual report had been accurate, the stock analysts interviewed by the *Journal* would not have commented positively on the company, the *Journal* would not have reported favorably on the company's prospects, and she would not have relied on the article and purchased the company's stock.[72] The court determined that plaintiff established reliance by showing that she acted in response to information based on a material misrepresentation or omission transmitted by reporters or workers in the securities markets.[73] To prove causation,

64. *Id.*

65. 524 F.2d at 907.

66. *Id.* "Requiring direct proof from each purchaser that he relied on a particular representation when purchasing would defeat recovery by those whose reliance was indirect, despite the fact that the causational chain is broken only if the purchaser would have purchased the stock even had he known of the misrepresentation." *Id.*

67. *Id.*

68. *Id.*

69. 549 F.2d 686 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977).

70. *Id.* at 695. Plaintiff had a right to rely "on the integrity of the regulatory process and the truth of any representations made to appropriate agencies and the investors at the time of original issue."

71. 663 F.2d 365 (2d Cir. 1981), *cert. denied*, 458 U.S. 1107 (1982).

72. *Id.* at 367.

73. *Id.* "Where the plaintiff acts upon information from those working in or reporting on the securities markets, and where that information is circulated after a material misrep-

the plaintiff was required to show that the defendant's fraud was a "substantial factor" or "significant contributing cause"[74] of her injury.[75] The court analogized to the *Blackie* opinion, stating that just as a material misrepresentation or omission is presumed to affect the price of stock, so it should be presumed to affect the information "heard on the street" which leads investors to make purchases in the secondary stock market.[76]

Vervaecke v. Chiles, Heider & Co., Inc.,[77] mentioned in *Raney* as conflicting[78] yet not distinguished, is not based upon the "entitled to be marketed/fraud on the market theory" alleged in *Raney*. The plaintiff did not allege that the bonds were not entitled to be on the market, but instead that the bonds were distributed with a fraudulently prepared offering statement containing affirmative misrepresentations which distorted their value. Thus, this opinion is not controlling or persuasive to *Raney*. Vervaecke sought compensation for the decline in value of the bonds measured by the difference between their cost and their present fair market value. He attempted to classify his claims as involving nondisclosure to benefit from the *Affiliated Ute* presumption of reliance, but the court determined that the plaintiffs alleged material misrepresentations and omissions in the nature of misrepresentations under clause (2) of Rule 10b-5, to which the *Affiliated Ute* presumption did not apply. The court also declined to distinguish or discuss *Blackie* which, arguably, is persuasive in this context. Vervaecke was unable to sustain his burden of proof of reliance on the misrepresentations because he did not view the offering circular until after he committed to purchase the bonds. The Eighth Circuit affirmed the lower court's summary judgment against his claim.[79]

The most persuasive authority for the holding in *Raney* is *Shores v. Sklar*,[80] a class action suit brought by purchasers of industrial revenue bonds following their default. A distinctly divided en banc Fifth Circuit panel[81] allowed the class to maintain a claim under 10b-5(1) and 10b-5(3) based on a variation of the fraud on the market theory which allows the investor to rely on the integrity of the market to the extent that the securities offered for sale to him must be ones which are entitled to be in the marketplace. The complaint alleged that the bonds were marketed under a fraudulent scheme so pervasive, that without it, the bonds would not have been offered on the market at any price. The Fifth Circuit affirmed the trial court's summary judgment against Shores' 10b-

resentation or omission, plaintiff has stated a sufficient claim of reliance on the mispresentation."

74. Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 28, 34 (2d Cir. 1976).

75. *Panzirer*, 663 F.2d at 367.

76. *Id.* at 368.

77. 578 F.2d 713 (8th Cir. 1978).

78. 717 F.2d at 1333.

79. 578 F.2d at 720.

80. 647 F.2d 462 (5th Cir. 1981).

81. 12 in the majority, 10 in the dissent.

5(2) claim based on an offering circular which was, allegedly, defective because it contained material misrepresentations and omissions. Shores' admission that he purchased the bonds based solely on his broker's oral representations and that he had not read or otherwise relied on the offering circular operated to disprove reliance, a necessary element in his claim under 10b-5(2).

The *Shores* majority interpreted the plaintiff's complaint as alleging that "fraud on a broader scale"[82] caused the bonds to be offered for sale on the market. Thus, it was the presence of the bonds in the marketplace that was challenged, not the effect of the offering circular on the purchasers' decisions to invest. The majority classified the offering circular as only one element of the overall scheme to defraud and held that nonreliance on this one component was not fatal to the claim. The court determined that plaintiff's burden of proof was to establish: (1) that defendant fraudulently marketed securities, (2) that he reasonably relied on the bonds' presence in the market to represent their legitimacy, and (3) that he was injured as a result of the fraudulent scheme.[83]

The dissent's examination of the case law found that clauses (1) and (3) of Rule 10b-5 have been applied in situations where clause (2) is inappropriate.[84] The language of clause (2) is specific, requiring the making of an untrue statement of a material fact or the omission of a material fact necessary to render the statements made not misleading. The first and third clauses are phrased less restrictively to include "any device, scheme, or artifice to defraud," or "any act, practice, or course of business which operates . . . as a fraud . . . ."[85] The dissent concluded that clauses (1) and (3) were drafted broadly to include fraudulent activities not covered by the particular language of clause (2).

The dissent criticized the majority's position in sustaining the plaintiff's claims under 10b-5(1) and 10b-5(3) as permitting allegations of misconduct in connection with the preparation and distribution of a misleading offering circular covered by 10b-5(2) to be recognized as causes of action under clauses (1) and (3) because of extensive allegations of collateral misconduct. The dissent argued that the majority allowed the plaintiff to circumvent the traditional reliance requirement of clause (2)[86] by acknowledging an "entitled to be marketed/fraud on a broader

82. 647 F.2d at 472.

83. *Id.* at 469-70.

84. *Id.* at 473-74 (Randall, J., writing for the dissent).

85. Rule 10b-5 provides in part:

> 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, . . .
>
> (a) to employ any device, scheme, of 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 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.

17 C.F.R. § 240.10b-5 (1984).

86. *List*, 340 F.2d at 462. The traditional reliance requirement is "whether the mis-

scale" theory of recovery despite the plaintiff's admitted lack of reliance on the offering circular.[87]

While the majority interpreted the primary purpose of the securities laws to be the protection of investors and the promotion of free and honest securities markets achieved through full disclosure and other means, the dissent determined that the fundamental purpose of the Acts was to fully disclose the terms of the transaction to the investor allowing him to make an informed investment decision. From the dissent's perspective, the majority's validation of plaintiff's 10b-5 claim, despite his admitted nonreliance on the offering circular proffered to promote full disclosure, contradicted the philosophy of the Acts. The dissent believed that the majority position would allow plaintiffs to recover in some instances, even though they did not read or rely on the defendants' public disclosures.

The *Raney* opinion acknowledges that the *Shores'* court was almost equally divided in its decision, but makes only an abbreviated attempt to address the concerns of the *Shores'* dissent. The primary concern is that the presumption of reliance extended in *Raney* could operate as a scheme of investor's insurance. When an investor successfully states a claim under the "entitled to be marketed/fraud on the market" theory, the issue of whether he took steps to protect his interest, namely by reading an offering circular or a bond opinion, is irrelevant. The *Shores'* dissent speculated that despite the material misrepresentations and omissions in that offering circular, if the plaintiffs had read it, they would have been warned by its patent defects. The *Raney* court does not discuss the degree of credibility of the bond opinion or offering circular. The investor need only establish that he "reasonably relied on the availability of the bonds as indicating their lawful issue"[88] to establish causation.

Raney cited *Arthur Young & Co.* to illustrate the expansion of the fraud on the market theory to "reliance to the integrity of the regulatory process and the truth of any representation made to appropriate agencies and the investors at the time of original issue,"[89] but omitted the truthfulness clause in its discussion of the case. The *Raney* court reasoned that investors are entitled to rely on federal and state securities regulations to produce lawfully issued securities. The court, however, attached a broad disclaimer which significantly eroded its rationale. The court did not grant investors the right to rely on the truthfulness of the offering circular. Despite this disclaimer, the court believed its holding did not create a "scheme of investors' insurance."[90]

If the *Raney* holding does not allow an investor to rely on the truthfulness of the statements made in the disclosure documents, then it pro-

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representation is a substantial factor in determining the course of conduct which results in . . . loss." *See Raney*, 717 F.2d at 1332.

87. *See Shores*, 647 F.2d at 481-87 (Randell, J., writing for the dissent).

88. 717 F.2d at 1333.

89. 549 F.2d at 695.

90. 717 F.2d at 1333 (quoting *List*, 340 F.2d at 463).

tects the investor who neglects or declines to read a patently erroneous offering circular. While *Arthur Young & Co.* protects investors who actually read deceptively misleading disclosure statements, *Raney* extends protection to investors who may or may not have read disclosure statements which may or may not be patently misleading. Federal securities regulations require disclosure statements to provide investors with information on which to base their decisions. It is difficult to rationalize how the protection offered by *Raney* to investors who do not read disclosure documents does not establish a scheme of investors' insurance when the disclosure documents are patently erroneous when read by the reasonable investor or securities broker.

The Tenth Circuit sustained Raney's 10b-5 claim under the guise of a "fraud on the market" theory. The label attached to this theory of liability implies two premises: (1) an actionable fraud, (2) which is perpetrated on a market. Raney established a sufficient claim under Rule 10b-5, but the opinion does not reflect any evidence introduced to show this fraud was practiced on a market. The customary interpretation of the term "market" in the context of securities transactions is based on the concept of an organized forum where securities are actively traded. It is composed of a primary market for original issues and a secondary market where prices are determined by supply and demand. The securities in *Raney* were Irrigation Fuel Authority Bonds purchased by sixty local investors at their original issue. The bonds did not have a secondary market and their value and selling price were calculated from their bond rating. There was no market for the bonds in the commonly accepted sense. The cases prior to *Shores* applied the fraud on the market theory to claims involving actively traded securities.[91] The "entitled to be marketed/fraud on the market theory" created in *Shores* and accepted in *Raney* is a misnomer. A fraud was committed, but not on a market. The fraud was committed on the bond investors themselves.

Lynn Bolinske

91. *Blackie* and *Panzirer* involved stock purchases in the secondary market. *Arthur Young & Co.* involved 1215 investors in limited partnership interests which were promoted as tax shelters.