OFFICIAL TRANSCRIPT
PROCEEDINGS BEFORE

THE SUPREME COURT OF THE UNITED STATES

DKT/CASE NO. 83-1961

TITLE LANDRETH TIMBER COMPANY, Petitioner V. IVAN K. LANDRETH, ET AL.

PLACE Washington, D. C.

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IN THE SUPREME COURT OF THE UNITED STATES

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LANDRETH TIMBER COMPANY,

Petitioner

v. No. 83-1961

IVAN K. LANDRETH, ET AL.

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Washington, D.C.

Tuesday, March 26, 1985

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:05 a.m.

APPEARANCES:

JAMES LINWOOD QUARLES III, ESQ., Washington, D.C.; on behalf of the Petitioner.

JAMES A. SMITH, JR., Seattle, Washington; on behalf of the Respondents.

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C O N T E N T S

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P R O C E E D I N G S

CHIEF JUSTICE BURGER: Mr. Quarles, I think you may proceed whenever you're ready.

CRAL ARGUMENT OF JAMES LINWOOD QUARLES III, ESQ.,

ON BEHALF OF THE PETITIONER

MR. QUARLES: Thank you, Mr. Chief Justice, and may it please the Court:

With the Court's permission I'd like to reserve five minutes of my allotted time for rebuttal.

In November 1977, seven and one-half years ago, the common stock of Landreth Timber Company, located in Tonasket, Washington was sold pursuant to a stock purchase agreement. More than six years have now been devoted to litigating the question of whether those shares bearing all the common, ordinary, traditional attributes of common stock are securities.

If the parties' reasonable expectations in 1977 are relevant -- and this Court has declared that they are in the Forman decision -- then it is appropriate to examine what the state of the law was in 1977 when the parties structured their transaction and what has happened to the law since then.

In 1977 the federal securities laws had been in place for more than 40 years, and this Court had applied them to a broad variety of transactions,

including private transactions in cases such as Bankers Life and to transactions involving the transfer of control in TSC Industries v. Northway.

In 1977 when the parties structured this transaction, no court of appeals had published an opinion holding that common stock would lose its status as a security if sufficient numbers of those shares were exchanged to transfer control. Indeed, in the relevant circuit, the Ninth Circuit, the Ninth Circuit had twice applied the federal securities laws to the ultimate purchase of one hundred percent of the stock of a business in Pratt v. Robinson in 1950 and in Mathison v. Armbrust in 1960.

In 1981 the certainty which had existed for almost 50 years was replaced by substantial uncertainty. The Seventh Circuit held in 1981 that stock might not be a security if it was exchanged in a transaction which wasn't also an investment contract. The circuits began to do battle. The Tenth and Eleventh Circuits joined the Seventh Circuit.

In 1984 in the present case the Ninth Circuit joined those circuits -- the Seventh, Tenth and Eleventh -- and told the petitioner that the stock which had been purchased seven years earlier was not a security and that the petitioner was remitted to the state law

remedies of contract and fraud, precisely the remedies Congress had determined were inappropriate when it enacted the 1933 and 1934 acts.

QUESTION: Mr. Quarles, I suppose the form the transaction took was largely guided by tax reasons, wasn't it?

MR. QUARLES: There was no -- as to my clients there was no choice involved. The seller in this case, Mr. Landreth, insisted from the outset that the transaction be structured as a sale of securities.

QUESTION: Rather than the assets

MR. QUARLES: That is correct.

QUESTION: Had it been of the assets, I suppose we wouldn't be here today.

MR. QUARLES: I'm not certain that that's correct, Your Honor. The situation which is involved here, involving the sale of assets, also involved services which were to have been provided by the -- by Mr. Landreth, the seller. We certainly wouldn't be here arguing about the question of stock, but we might be here trying to determine whether this was an investment.

In contrast to the decisions of the Seventh and Ninth Circuits, five other circuits have declared that common stock is always common stock. The Fourth Circuit has adhered to its decision in Occidental, the

first decision in 1974. The Fifth Circuit has emphatically rejected the doctrine in its Daily v. Morgan decision. The Second Circuit has done so twice in Seagrave and then in Golden v. Garafalo. And finally, in what I submit is a very scholarly and persuasive opinion, Judge Gibbons of the Third Circuit has exhaustively considered the arguments for writing some stock transactions out of the definitional sections of the act, and emphatically has rejected what has come to be known as the sale of business doctrine in a case which will be argued this afternoon, Ruefenacht.

Your Honor, I submit that the uncertainty in the application of the securities laws arose in 1981 because the Seventh and ultimately the Ninth Circuit shifted their focus from the instrument being sold to the transaction in which it was sold; and they then required that the transaction, not the instrument, meet the definition of an investment contract, or in the Ninth Circuit's variation of that, risk capital test.

It bears repeating, I think, what the Ninth Circuit's approach does. This Court has always focused upon what the character of the instrument was when it was created, not the method by which it was exchanged. The Ninth Circuit reverses that focus and focuses completely on the transaction in which it is exchanged

and ignores the instrument being exchanged.

To hold Landreth Timber's -- that Landreth Timber's conventional stock was not a security is surely a strange use of the language, and I submit a misuse of the statutory language. The instrument which we are talking about today and which was purchased seven years ago was held by both the district court and recognized by the Ninth Circuit to possess, and I quote, "the ordinary characteristics of stock." It bore all of the characteristics of stock which have been identified by this Court: the right to dividends, negotiability, voting rights in proportion to the number of shares owned, and the prospect of appreciation.

I submit that any reasonable person in 1977 would have understood themselves to be engaged in the purchase of a security. The principals of the purchasing group, for example, were a Mr. Samuel Dennis and a Mr. John Bolten. Mr. Dennis was at the time he received a solicitation which touted the prospects of an attractive return upon the capital to be invested, not an opportunity to earn a living in the lumber business. Mr. Dennis was then a 67-year old lawyer residing in Boston, Massachusetts, completely across the continent from Washington State.

The other principal investor, the late Mr.

Bolten, was then 84 years old and living in Florida. Neither of them were interested in moving to Washington State to undertake new careers as lumbermen.

The representations, and we submit the misrepresentations, that were made to induce these gentlemen to purchase this stock were typical of the representations that were made to induce the purchase of stock. In addition to representations concerning the existing contracts which the company had, the liabilities which were to be assumed, representations were made that the company's mill, which had earlier been destroyed by fire, was being reconstructed on schedule, was being reconstructed out of the insurance proceds, that the additional construction costs to the purchasers would be minimal, that it could operate after reconstruction on a two-shift basis, that it would produce as much as twice the industry standard of lumber per log, that it would produce profitable, high grade timber, and that it would produce an acceptable return on the investment, on the capital that was to be invested.

The falsity of those representations resulted in the expenditure of more than $500,000 additional to the amount that was represented as the cost of reconstructing the mill. Undisclosed liabilities

surfaced. Even after the mill was reconstructed at substantial additional expense, it never performed as represented and was ultimately sold at a foreclosure sale. And further, as I mentioned with Mr. Justice Blackmun, the transaction was structured as a sale of stock. It was done so at Mr. Landreth's insistence.

Pursuant to the stock purchase agreement that is involved here two things changed hands on November 17, 1977: 500 shares of Landreth Timber Company's conventional stock, and $3,400,000. Indeed, the parties' expectations is perhaps best illustrated when Mr. Landreth was confronted with the overrun and challenged as to the representations which were made. He responded, "I sold stock. I didn't sell anything else."

The petitioner sued in this case in November of 1978. Extensive discovery was conducted for more than three years on petitioner's claims that the anti-fraud provisions of the 1933 and 1934 acts had been violated and dependent state law claims. However, when the Seventh Circuit issued its first sale of business doctrine decision, the defendants moved for summary judgment, asserting that the shares they had sold were not securities. The district court granted summary judgment, holding that every security, whatever the

instrument may be, must meet the definition of an investment contract; and that this transaction, even though it involved stock with all of the ordinary characteristics of stock, could not do so.

And why couldn't it do so? According to the district court, the third requirement of the Howey test, a reasonable expectation of profits from the efforts of others, could not be met, the court held, because Mr. Landreth was merely a consultant. The Ninth Circuit affirmed, holding that the Howey investment contract test must be applied, and that the requirement of an expectation of profits from the efforts of others could not be met.

I submit that the analysis of the Ninth Circuit was wrong at every turn. It ignored the language of the acts, their structure and purpose, and it cannot be applied, I submit, without producing arbitrary, logical and unworkable results which will burden district courts in cases such as this for years to come.

QUESTION: Mr. Quarles, do you think that United Housing Foundation against Forman was incorrectly decided by the Court?

MR. QUARLES: On the facts of that case I do not. There, of course, the stock which was involved

this Court analyzed very thoroughly before it proceeded to the investment contract test. This Court looked at all of the attributes of common stock and found that the stock informant had none of them. The Court said if you look at this instrument, this instrument does not have the ordinary characteristics of common stock, and then proceeded to the investment contract test.

What the Ninth Circuit proposes and the other circuits who have adopted this doctrine propose is to eliminate the first part of this Court's opinion in Forman, and in every case to turn to the question can this meet the test of an investment contract.

I begin with what I believe to be the appropriate starting point for any statutory construction: the language of the statute. Both the 1933 and the 1934 acts define security to include the term "stock," an instrument with precisely the same well-settled meaning today that it had in 1933 when Congress acted.

Landreth Timber Company's stock is conceded to have all of the ordinary characteristics of that stock, all of the characteristics identified by this Court in Tcherepnin and again in Forman. But the Ninth Circuit said no, we're not going to look at that. We're not going to look at the definition of stock. The

appropriate definition for us to look at is the investment contract test.

I respectfully submit that such a construction of the statute turns the statute and its words on its head. The separately listed instruments which precede investment contract are meaningless unless they have some meaning different from investment contract. And this Court held in Joiner that the more general terms in the statute were meant to expand, not to limit the more specific terms which they followed.

Furthermore, this Court declared only two years ago in Marine Bank that the statutory definition "includes ordinary stocks and bonds." This Court has applied the investment contract test only to atypical instruments which could only be securities if they met the investment contract test. First, the orange groves in Howey; next, the leases of land next to oil wells in Joiner; the withdrawable shares in Tcherepnin; the lease deposits in Forman; the pension fund in Daniels; the profit-sharing arrangement in Marine Bank. That this Court applied the investment contract test in those cases is scarcely remarkable. That is what the parties claimed the contract was, an investment contract.

Accordingly, I submit there is no warrant in the statute for holding that only an investment contract

is a security.

Turn next, if you will, to the violence which the Ninth Circuit's opinion does to the structure of the 1933 and the 1934 acts. Application of those acts, an important consideration for parties as they structure transactions, and for their counsel who advise them as they structure those transactions, turns on whether an instrument is a security, so that it is critical to know either that a security always is or never is a security. That is the fundamental purpose of having the definitional section determine whether an instrument always is or never can become a security.

When Congress wanted to exempt a specific transaction, it had no difficulty whatsoever in doing so. But the Ninth Circuit's approach results in the following anomalous situation: the same instrument can be a security at some time and in some people's hands but not at other times and not in other people's hands.

This case presents a graphic example of that. Mr. Landreth's two sons each owned 60 of the 500 shares of Landreth Timber Company stock -- not enough to constitute control under any test. Under the Ninth Circuit's reasoning, they presumably sold securities because they weren't selling anything that looked like controls, although on the other hand, the purchasers who

acquired those securities did not buy securities because, according to the Ninth Circuit, somehow control was involved.

But if we move to the next day and the purchaser sold those precise same 60 shares in a public offering, apparently under the Ninth Circuit reasoning those same instruments would have become securities again.

That result is not only anomalous but is in sharp contrast to the carefully constructed pattern of the 1933 and 1934 acts. In those acts Congress exempted some transactions or some securities from some but not all of the provisions of those acts.

But there's more than just an offense to the statutory pattern if you try to graft this doctrine onto a securities law to which it was a stranger for more than 50 years. Examine for just a moment the difficulty which a district court will be required to grapple with every time someone says I didn't sell a security; my transaction wasn't an investment contract.

Both the Seventh and the Ninth Circuits apparently make the presence of control the determinant. The Seventh Circuits adds new gloss to it. They say that perhaps it will be helpful for a district court to grapple with the question of whether

somecne was an investor or an entrepreneur.

Now, the Ninth Circuit ignored these issues in the case that was before it, because they focused upon the presence of a shell corporation which was formed tc acquire this stock. Let's look, however, for just a moment at the economic realities which underlie this transaction.

There's no dispute that they are as follows. The petitioner here was a shell corporation formed for the sole purpose of acquiring Landreth's shares and then merging with Landreth Timber. Mr. Dennis, the gentleman who lived in Boston and was a lawyer, owned 50 percent of the voting shares of the resulting corporation. Mr. Bolten, the gentleman who resided in Florida and was retired, owned the other 50 percent of the shares. Six other people, two located in Massachusetts and four in Washington State, owned the remaining 15 percent of the equity but had no vote.

Neither Mr. Dennis nor Mr. Bolten was able to, as a result of ability or geographical proximity, to run Landreth Timber Company, so they made Mr. Landreth's services for a year a condition of sale, explicitly stated that if you won't stay as a consultant and help reconstruct this mill, and you won't help us for six months thereafter smoothing the transition, this deal

won't happen.

Now, if the district court is required to determine who had control in this situation, how does it determine between Mr. Dennis and Mr. Bolten? Neither could outvote the other. How is the district court to determine? What is the test that it should use?

The case this afternoon graphically demonstrates the variety of situations in which this question of control will be presented in the future. Will, for example, the purchase of an initial block of 49 shares, 49 percent of the stock be a security, but the purchase of the next 2 percent not be a security, or does the purchase of the second 2 percent require that the first 49 were not a security? Those types of questions will burden district courts endlessly.

Furthermore, if someone is to attempt to make a distinction between investors and entrepreneurs, a distinction which even the Seventh Circuit who adopted the distinction recognized to be fuzzy, I submit that it ignores economic realities to hold that acquiring Mr. Landreth's services by a consulting contract instead of by an employment agreement or some other form transforms Mr. Dennis and Mr. Bolten from the category of investors to entrepreneurs. Surely the result would not have been different in Howey if the citrus grove promoters had

been smart enough to structure their transaction to make themselves citrus consultants.

This uncertainty of application of the securities laws and the illogical results that it produces will burden lawyers and parties they advise as they structure transactions, and it will force district courts to struggle to determine whether they have jurisdiction and produce the potentially wasteful result which happened here three years into litigation, a determination that jurisdiction does not exist.

The Securities and Exchange Commission addressed in its amicus brief some of the problems which this changeable notion of now it's a security, now it's not, now it is again injects into their enforcement burdens, and presumably they will discuss that further this afternoon.

But I submit that the difficulty of applying the test which was proposed by the Ninth Circuit, the illogical results it produces, and the inability to reconcile the test which is proposed with the language of the acts, and the structure which Congress employed when it adopted those acts shows how far adrift this approach of the Ninth Circuit is from the statute and from the purposes behind it.

The federal securities laws are broad. They

are broad because Congress was legislating broadly and reacting to a broad lack of confidence which had been caused by the great crash and the ensuing depression. Congress was not dispensing its protection stingily attempting to determine whether this person should be denied coverage because of some transactionally based exemption. Congress was legislating broadly in an attempt to restore investor confidence and to lure capital which Congress had found to become timid to the point of hoarding back into the capital markets.

QUESTION: May I just interrupt with one question? I suppose the other side of the argument is that Congress might not really have been thinking about the scope that your rule will carry federal jurisdiction. I guess you would find a violation of 10(b)(4) every time there's an allegation of breach of warranty or any misrepresentation of any kind in any private sale of stock.

MR. QUARLES: I would say that 10(b)(5) and its requirements would apply, as this Court has held, in private, face-to-face negotiations as well as in negotiations which occur over the national --

QUESTION: And in every case in which any warranty in a contract with respect to the financial condition of the company is alleged to have been

misleading or breached in some respect.

MR. QUARLES: Upon a demonstration of the proof of the requisite sienter and the other requirements of 10(b)(5), that would be correct.

QUESTION: Would it be co-extensive with common law fraud actions and breach of contract, or a little broader, I suppose?

MR. QUARLES: It is substantially different, Your Honor. One of the questions that is presented by this case is what happens if you say this instrument is not a security. Many state law security statutes employ exactly the same definition as the federal laws do. That's essentially the case in Washington State. Washington State also says that its statute is to be construed conformably to the federal statute. So as a result of holding that this is not a security for federal purposes, you may well have, as my brother has indicated he will argue in the state court if that's where we're remitted, you may have decided that there was not a state security sold.

QUESTION: But you still have your state common law action which you --

MR. QUARLES: Washington -- this Court said just two terms ago in Huddleston and McLean that the burden of proof upon a defrauded purchaser is

preponderance of the evidence. My brother will argue, if we're ever forced to return to the state courts, that Washington's standard ought to apply, which is clear, cogent and convincing evidence -- a standard which Congress presumably knew about when it decided that securities instruments ought not to be subjected to state law remedies.

QUESTION: Do you think there's anything in the legislative history that shows Congress thought it was giving federal jurisdiction for a suit like this?

MR. QUARLES: Yes. We have cited in our brief the one point in the legislative history in which Congress turned to the question of what about someone who puts together a corporation, runs it for a while, and then turns it -- makes it available to the public.

What happened in this situation if you look at the economic realities is a corporation run in Washington State was made available to a Mr. Dennis, who lived in Boston. Certainly interstate commerce was required.

QUESTION: You rely on the interstate advertising and all that. But I suppose your case would be the same if they just called him up on the phone and said I've got a good deal for you, and they didn't have any public advertising or anything like that.

MR. QUARLES: My case would be the same since they would have used an instrumentality of interstate commerce. But they also would have had to speak to Mr. Bolten, who resided in Florida. Surely had Congress been asked are we to be thought to legislate stingily and to be hoarding the protection we're giving, or are we intending to grant broad protection, Congress would have said we mean broad protection.

Indeed, that is why I suggest Congress afforded new remedies and required full disclosure to persons who dealt with certain favored instruments, whether they dealt with them face to face, privately negotiated, or on the exchanges.

This Court has repeatedly recognized the breadth of Congress' intent. In one of this Court's earliest decisions under the securities laws, and ironically one on which the respondents rely heavily, Howey, this Court concluded its opinion by saying the statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

The sale of business approach which the Ninth Circuit adopted is, I submit, just such an unrealistic and irrelevant formula. It should be rejected and the Ninth Circuit's judgment reversed.

Thank you. I'd like to reserve the remainder of my time for rebuttal.

CHIEF JUSTICE BURGER: Very well, Mr. Quarles.

Mr. Smith.

ORAL ARGUMENT OF JAMES A. SMITH, JR., ESQ.,

ON BEHALF OF THE RESPONDENTS

MR. SMITH: Mr. Chief Justice, and may it please the Court:

As may be expected, respondents and petitioner agree on very little, including the definition of the parties in this case.

My clients are Ivan Landreth and his family, who were sellers in November of 1977 of a sawmill which was incomplete, under reconstruction, wasn't operating, was not an ongoing business. It was a closely held family corporation. And the adverse party in this case, who Mr. Quarles represents, although he makes extensive efforts to describe it as an individually owned entity, is in fact a corporation named Landreth Timber Company. Landreth Timber Company is the successor in interest to B&D Company, which Mr. Quarles' clients formed for the purpose of purchasing 100 percent of the stock of Landreth Timber. The petitioner is and always has been a single corporate entity, and I submit that's important.

The issue in this case is whether the

privately negotiated sale of a closely held business, accomplished through the transfer of a hundred percent of its stock to a single corporate purchaser, is a security under the 1933 and the 1934 acts. And that has to be evaluated in light of two major principles that run through 40 years of this Court's decisions.

Number one, after this sale there was no common enterprise of any kind between Mr. Quarles' clients and my client, the seller, or for that matter any other party. There was no intertwining of investor fortunes after this sale. That's essential to this Court's definition of a security.

And second, the record below unequivocally shows that the petitioner in this case assumed complete, one hundred percent control of the business, and from the day the sale closed proceeded to operate it as its own business. And that does not satisfy this Court's test of whether there has been an investment in a common enterprise premised upon a reasonable expectation of profits to come from the entrepreneurial or managerial efforts of others. The district court so found, and so did the Ninth Circuit.

Now, Mr. Quarles says the law underwent a massive shift in 1981, that this new sale of business doctrine was injected into the law regarding

securities. I submit that that's incorrect. This Court since 1943 in the Joiner decision and then in 1946 in the Howey decision in each and every of six decisions has looked at the economic realities underlying the transaction. And the test, the test which we say should be overlaid on this private transaction, is the same test which the Court announced in SEC v. Howey in 1946.

There's nothing new about this test, and we submit that the question before the Court is not whether a new sale of business doctrine test should be adopted, but whether the Court should continue to apply the economic realities test, which it enunciated in Howey, which Forman said is the touchstone that underlies all of the Court's decisions regarding a security, which Forman said for our purposes is no different than the definition of a security which has been consistently applied by this Court.

Now, I'd like to summarize what respondents' position is in this case. We start with the structure of the acts, and I invite the Court in response to petitioner's point to consider the structure of the acts.

The 1933 and '34 acts say unless the context otherwise requires, and then proceed to identify approximately 17 different instruments. Stock, which I notice Mr. Quarles referred to as a specialized

instrument, an instrument that deserves special protection, is not even the first instrument listed. The first instrument listed is notes, notes -- notes, something that we have, all have common understanding of what constitutes a note. But can you decide whether a note by itself is a security under the 1933 act without the application of additional economic criteria?

There's nothing in the structure of the acts which gives stock any more dignity than any other term under the act, than the term investment contract, then the term notes, than the term debenture, the term bonds. That's the structure of the act.

Why is that preceded by the context clause? Well, petitioner argues in its brief that the contect clause is sort of just another context clause like 40 some other federal statutes that say unless the context otherwise requires.

The problem with that is this Court, this unanimous Court in Marine Bank in 1982 said the context clause had considerable importance. It was the bridge for the application of the economic realities test to the very instruments that the Court would have to consider whether or not it constituted a security.

Is stock lying on this table, on counsel table a security? I submit it's not. I submit we can't

tell. We have to look at the transaction.

What did Congress say in the legislative history? I'm not going to stand here and tell this Court that Congress solved this problem in 1933 and 1934. In fact, I think the fact that Congress didn't discuss this problem in 1933 and 1934 says that it frankly is not a situation where we have an abuse; that is, where a purchaser is taking over a hundred percent of the business that Congress intended to protect with the acts.

QUESTION: Well, Mr. Smith, I guess Congress did decide to include private transactions within the coverage of the anti-fraud provisions, didn't it?

MR. SMITH: That's correct, Your Honor. And I'm not arguing that this is exempt because it's a private transaction. In fact, I'm not arguing it's exempt at all. I'm arguing that because of the economic realities of this transaction, it is in fact not a security. Unquestionably the security laws apply to private transactions as well as public ones.

QUESTION: Somewhere in your argument you will discuss the effect of your position on the Williams Act, I take it?

MR. SMITH: Well, the Williams Act which, as the Court is well aware, applies to tender offers, I

submit evidences a very particular congressional intent to protect persons, non-sellers or investors in a tender offer situation. I certainly would not suggest that the sale of business doctrine should in any way affect the requirement under the Williams Act that someone in a takeover or tender offer situation disclose that intent.

Now, the next level is whether someone who takes over a majority interest or control in a corporation as a result of a tender offer should have --

QUESTION: Or 100 percent.

MR. SMITH: Yes. Yes, Your Honor. Whether that party should be denied the protection of the acts. And I think there's a threshold question there. The threshold question is whether the economic realities test should be applied to publicly traded stock. I think logically and consistently it could be applied to publicly traded stock, but in the same breath I recognize that Congress had a special interest in protecting the integrity of the market. And it may well be that this doctrine should be confined to private transactions.

And in Marine Bank this Court in 1982 put heavy emphasis on the fact that it was a privately negotiated transaction. And I think -- I can't deny that that's important.

Now, what are the economic criteria to determine the existence of a security under the 1933 and 1934 act? Well, it wasn't long after those acts were enacted that this Court had to deal with that, and it determined that the criteria was whether there was an investment in a common venture premised upon a reasonable expectation of profits to come from the entrepreneurial or managerial efforts of others.

Now, it's critical to petitioner's argument to confine that test, which has been used at least five times by this Court starting with Howey, to the investment contract test of SEC v. Howey. Well, I submit that the Court has in Forman spoken to that and said in talking about an instrument, admittedly an atypical instrument that was called stock, that that was the test that applied to all of its decisions regarding what was a security, and that it did not perceive a difference between that test and the test to be applied to what constituted a security.

Applying the economic realities test of Forman to this case, which perhaps presents the purest instance in which this Court can consider this issue, and it's going to have to consider Ruefenacht this afternoon, it can be seen first and foremost that there is no common enterprise here. And the Court's never addressed the

common enterprise requirement before. Justice White wrote a dissenting opinion from the denial of cert in the Mordaunt case which was submitted in January of this year, and in that case the issue was whether the Court had to buy vertical commonality or horizontal commonality for purposes of common enterprise.

Well, fortunately, you don't have to reach that issue in this case. The fact of the matter is after the date of this sale there was no intertwining of investor fortunes between the petitioner and anyone else, either my client or any other investor. That is not typical of a security.

Secondly, in applying the economic realities to this case, the admitted fact --

QUESTION: May I ask just to be sure I follow it as you go through, does that mean that you would agree there was a security if they had sold 40 percent of the company to these people?

MR. SMITH: What it means is I would agree that there was a common enterprise and that that requirement would be satisfied, Justice Stevens.

QUESTION: Does it further mean you would agree there was a security in that event?

MR. SMITH: It means that the district court would have to take a very hard look whether that

purchaser objectively, not subjective reliance but objectively under the circumstances of this particular case acquired control sufficient --

QUESTION: I said 40 percent. He did not acquire control. He said 40 percent of the company to the purchaser instead of 100 percent.

MR. SMITH: Yes.

QUESTION: Would that be a covered transaction, in your view?

MR. SMITH: The test would be whether or not the purchaser obtained control over the outcome of the investment.

QUESTION: You're saying he didn't. The seller retained 60 percent.

MR. SMITH: Oh, in that instance I would say no. I'm sorry.

QUESTION: You would say it was not a covered transaction.

MR. SMITH: Yes.

QUESTION: But if he sold 60 percent, it would have been a covered transaction.

MR. SMITH: I'm sorry. I think I've totally reversed your hypothetical.

QUESTION: I thought you did, too.

MR. SMITH: If the purchaser obtained 60

percent --

QUESTION: No. My first question is the purchaser buys 40 percent of this company.

MR. SMITH: Yes.

QUESTION: And the seller retains the remaining 60 percent.

MR. SMITH: Yes.

QUESTION: Is the transaction covered or not?

MR. SMITH: I believe so.

QUESTION: It is?

MR. SMITH: Yes.

QUESTION: But it's not covered if he gets 51 percent.

MR. SMITH: Depending upon whether that 51 percent under the circumstances of the case provided actual control of the purchase. That may not depend entirely on percentages.

QUESTION: But if it was a 40 percent price, we are clear that would be a security and all the economic realities would satisfy your standard.

MR. SMITH: Unless there was some sort of unique veto power or authority to run the business given to the purchaser.

QUESTION: No gimmicks. No gimmicks.

MR. SMITH: Thank you. I apologize for

confusing the --

QUESTION: No. I just wanted to be sure.

MR. SMITH: I'd like to turn for a minute to the record below, because I think this Court should be quite clear what case it has before it, and I'm not sure it's the case as described by petitioner.

This district court -- and I submit when we talk about burdens on courts, this district court acted very effectively and efficiently in analyzing whether or not control passed to this purchaser at closing. It told the parties after an evidentiary hearing to exchange admissions to perfect the record, and here is what the petitioner admitted below: "That under the stock purchase agreement my clients agreed to sell 100 percent of the stock in Landreth Timber to a corporation to be formed by the purchasing group; that they agreed to, my clients, and did resign as officers and directors of LTC-1;" -- that's Landreth Timber Company 1 -- "that none of the respondents became officers, directors, shareholders or employees of the acquiring company or held any interest in it; that none of the selling parties had any right to share in the profits or losses of the successor corporation; that the purchasing group" -- which Mr. Quarles has described as Mr. Sam Dennis and Mr. Bolten on the East Coast -- "in fact acted prior to

closing and hired their own mill manager who they put in place on the date of closing who ran the business; and that Ivan Landreth was retained under a terminable at will consulting agreement under which he had no real power and was in fact terminated within two months of the date of closing."

We submit those admissions establish rather clearly before this Court that absolute and total control passed to the purchaser at the time of closing.

Now, I'd like to turn to some major principles that I think come out of this Court's decisions. And this Court certainly, despite the suggestion to the contrary, does not write on a clean slate or a blank slate with respect to the propositions urged by petitioner.

Number one, no case that this Court has decided stands for the proposition asserted by the SEC and the petitioner that so long as an instrument is named in the acts and that it is what it pretends to be -- that is, that it has some traditional characteristics -- that it is a security and that the inquiry ends.

In fact, the sole source of that argument is a single sentence in the Joiner decision that this Court rendered in 1943 before its decision in Howey in 1946. And in that case the Court said instruments may be

included within any of these definitions as a matter of law if on their face they answer to the name or description.

Well, the same argument that's been made to this Court today was made to this Court in Forman in 1975, and the Court looked at precisely that language and here's what the Court said about it: by using the conditional words "may" and "might" in these dicta, the Court made clear that it was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction.

So it's petitioner that's coming before this Court and urging what essentially is a new rule; that is, for this most protected type of instrument, stock, that a literal characteristics test should be applied. That's never been applied by this Court before. And what road does it send the Court down?

There's been much said about the line drawing that district courts will have to do in applying the economic realities test, and there is, incidentally, no line drawing on the basis of this record. But what road does the Court have to go down if it adopts a literal characteristics test?

Well, the Court would establish, I suppose, for stock, one of the named instruments under the acts,

a test which would make it stock simply because it was what it pretended to be irrespective of the economic realities of the transaction. Unfortunately, the Court would still have the investment contract test, what Mr. Quarles would confine to be the investment contract test of Howey, which the Forman court said was an economic realities test underlying all of its decisions, and it would have to determine which instruments that would apply to.

Then we've got Marine Bank v. Weaver in 1982 where the Court looked at a certificate of deposit and said in the circumstances of that case that that was not a security. The SEC and petitioner would argue with respect to that particular decision that there is another test to be applied; that is, the overwhelming scheme of federal regulation; that because the federal government has regulated certificates of deposit, they can be accepted from the acts.

And then we would have to decide which instruments under the 1933 and '34 acts are typical versus atypical, and that's a definition that perhaps counsel can share with us in his rebuttal time, because I certainly can't provide it to this Court.

In each of its six decisions from 1943 to date, including the Joiner case, this Court has looked

at the underlying transaction in determining whether or not a security existed. It did so with assignments of oil leases and promises to drill in Joiner in 1943. It did so in SEC v. Howey in 1946 regarding a citrus grove, sale of citrus grove units coupled with service contracts. It did so in Tcherepnin v. Knight in 1967 with respect to something called shares, withdrawable capital shares in a savings institution. And in those three decisions the Court applied correctly, as petitioner would say, the analysis of the entire transaction in order to expand the coverage of the act, not restrict it, to make it clear that those named instruments aren't all that there was.

But then came Forman in 1975 where the Court held that something called stock quite simply was not a security, either under the literal characteristics test that petitioners proposed or under the investment contract test, as petitioners call it.

Teamsters v. Daniel in 1979 the Court addressed a noncontributory pension plan and determined it was not a security.

QUESTION: Do you think Forman, the opinion in Forman was influenced by the nature of what was sold and its utility?

MR. SMITH: I truly think not, Chief Justice.

QUESTION: It wasn't a sawmill type of an operation, was it?

MR. SMITH: That's correct, and it was a very unusual instrument. I'd readily concede that. But the framework of the Forman decision came up from the Second Circuit, and what had the Second Circuit decided? Two things: that number one, because it was stock, called stock, it in fact should be a security. And second, that if it was not stock under a literal characteristics approach, it was a security under an investment contract approach. And I think that explains the framework of the Forman decision. And in both parts of the decision the Court reiterated the Howey test and said we've got to look at the economic realities of the underlying transactions.

And I think Forman is critical. I think Forman is critical because it took the argument that the Howey test was an investment contract test, and it said, "We perceive no difference for present purposes between an investment contract and an instrument commonly known as a security." It went on to say, "The test, in shorthand form, embodies the essential attributes that turn through all of the Court's decisions defining a security."

I think Forman resolved a number of the

theoretical arguments that are being made now by petitioner.

QUESTION: Mr. Smith, may I ask you another question, just thinking of a little different kind of case? Suppose you had a listed stock, something you traded on the New York Stock Exchange, and there was a control block. To make my hypothetical easy, assume it's 52 percent of the stock, a negotiated transaction, and the purchaser gets resignations of directors and clearly gets the right to appoint the new management, and there's complete, you know, arm's length negotiation between two bargaining equals. Would that be covered or not under your view?

MR. SMITH: Well, as I said earlier, Justice Stevens, I think when we get into publicly traded stock, in all candor, there is an interest exhibited by Congress in the '33 and '34 acts that --

QUESTION: So your argument really doesn't apply to publicly traded securities at all.

MR. SMITH: Conceptually the logic's identical, but I think there might be good reasons that this Court should decide to draw the line with private transactions.

QUESTION: I see.

MR. SMITH: Now, there's something else about

this Howey test, this economic realities test which I submit is very important in the Court's resolution of this case. When the Court has applied this test it has determined that these criteria, this investment in a common enterprise with a reasonable expectation of profits to come from the efforts of others, have to be present in some very real and substantial degree.

An example: in 1979 in Teamsters v. Daniel the Court conceded that some part of the employee's work in fact was an investment. It went into the pension plan which would ultimately result in benefit to him. But the Court said what's really going on here? And what the Court stated was that what people really doing is working for a living, and a portion of their wages went into this plan, and it's not a significant investment.

Then the Court turned to the question of whether these employees were relying on the efforts of others for management of the plan. The Court conceded that there undoubtedly was some reliance on the efforts of others, but concluded it was not sufficient to meet the test.

Marine Bank even more emphatically talked about just in what degree these requirements of the economic realities test must be met in a private

transaction. There the Court said that the purchaser, who unquestionably was dependent upon the others for the repayment of a profit-sharing agreement, for the repayment of an investment, was not entitled to the protection of the securities acts because he had a degree of control that was inconsistent with the Court's prior decisions on what was a security.

And what was the control there? Well, that purchaser didn't manage the business. The purchaser did have the ability to use a pasture and horse farm, and the purchaser did have the ability to veto future loans. And the Court stated unanimously in 1982 that just is not indicative of the economic criteria we find to constitute a security.

Now, in applying the economic realities test to this case, I first would state that I believe petitioner has to convince this Court not to apply the economic realities test to stock in order to prevail. I don't think there's any question about that. Because under no construction of the common enterprise element of this Court's decisions under the economic realities test is there a common enterprise here.

And as the Court may be aware, the debate among circuits about common enterprise, it's sort of unquestioned that a horizontal pooling of funds

satisfies the common enterprise requirement. The question arises in vertical commonality, how involved is the seller with the purchaser with respect to the outcome of the investment.

We don't have either situation here. On the date this closed, they owned the entire business. They owned it as certainly as if they bought that equipment, as if they had purchased an automobile or anything else. It was lock, stock and barrel theirs.

QUESTION: Why didn't you insist on an assets transaction -- tax purposes?

MR. SMITH: I think -- quite admittedly, Your Honor, I think in the negotiations my client wanted for tax reasons to have it be a stock transaction.

QUESTION: Usually the seller does, and the buyer wants the assets.

MR. SMITH: Yes. And that's entirely correct.

I'd like to turn in conclusion to what makes good law, because ultimately that is the business that this Court is about.

Both sides hurl at each other charges of inconsistency and illogic. I think the starting point that this Court must recognize if it adopts petitioner's position in this case and the position of the SEC, which has been on both sides of this issue, that it is on the

road to adopting multiple tests for those 17 instruments under the act. And I submit that if Congress intended a multiplicity of tests, it would have given some particular dignity to those instruments far different than it did in the structure of the act.

The burden -- I heard Mr. Quarles' argument a number of times about the burden on federal courts. Anyone who has litigated a 10(b)(5) case to a conclusion can scarcely suggest that the burden on a federal court that properly -- under properly applied criteria, the economic realities test determines that something is or is not a security in the context of a hearing --

QUESTION: Well, don't you think that ten cases on this subject with five each way apparently has been a burden on the federal courts that was avoidable if there had been a single rule?

MR. SMITH: I certainly do. I certainly do, Chief Justice.

QUESTION: So the time has come for us to make a single rule, hasn't it?

MR. SMITH: It certainly has. And, in fact, with that perhaps it's a good time for me to sit down. I appreciate the Court's attention.

CHIEF JUSTICE BURGER: Do you have two minutes remaining, Mr. Quarles. We'll finish before lunch.

ORAL ARGUMENT OF JAMES LINWOOD QUARLES III, ESQ.,
ON BEHALF OF THE PETITIONER -- REBUTTAL

MR. QUARLES: Thank you, Your Honor.

My brother commenced part of his argument by asking me if perhaps I could enlighten you as to what I thought the difference was between a typical instrument and an atypical instrument.

A typical instrument is precisely what the Ninth Circuit held this stock to be. It's an instrument that answers to its name when it's called; it has all of the common attributes of the instrument as it's understood by all parties. And an atypical instrument is when you attempt to make an instrument bear a burden that it can't bear. You try to call stock, in Forman stock instead of a deposit upon a lease.

My brother spent a substantial portion of his time talking about the common enterprise and the requirement of a common enterprise. I suggest that there are two things that need to be considered. In this case summary judgment was granted, but the plaintiff, my client, argued below -- and there's really no dispute to his affidavit -- he would not have gone into this transaction located a continent away from him if he did not have the consulting services of Mr. Landreth who had run this enterprise for more than 30

years. So that the common enterprise that my brother looks for is surely there.

But if you're going to impose a common enterprise test, what do you do then about a promoter who takes a bundle of rights, bundles them up and sells 100 percent of them? Does he then say don't look at me; I didn't sell a security; we don't have a common enterprise.

Furthermore, the other point that I wished to speak to briefly was the suggestion that the limited purpose of this act suggests that this Court should somehow draw lines now, Congress having acted more than 50 years ago, and set up a series of tests that would help Justice Stevens resolve these cases in the future, and now draw a line. When Congress drew one a long time ago, Congress said those instruments are stock.

CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

(Whereupon, at 12:00 p.m., the case in the above-entitled matter was submitted.)

CERTIFICATION

Alderson Reporting Company, Inc., hereby certifies that the attached pages represents an accurate transcription of electronic sound recording of the oral argument before the Supreme Court of The United States in the Matter of:

#83-1961 - LANDRETH TIMBER COMPANY, Petitioner V. IVAN K. LANDRETH, ET AL.

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BY Paul A. Richardson

(REPORTER)