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DIVISION OF SECURITIES

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March 18, 1996

Mr. James R. Kruse
Kruse, Landa & Maycock, L.L.C.
Eighth Floor, Bank One Tower
50 West Broadway
Salt Lake City, UT 84101-2034

Re: Physician Management Company of Utah, L.C.
File # 5-3520-4/A53093-47
Request for Interpretive Opinion/No-Action Letter

Dear Mr. Kruse:

This letter is in response to your letters dated February 7, February 16, and March 8, 1996, wherein you request that the Utah Division of Securities ("Division") issue a No-Action Letter regarding the proposed offer and sale by Physician Management Company of Utah, L.C. ("PMC") of earned membership units in PMC without complying with the registration and prospectus delivery requirements of the Utah Uniform Securities Act ("Act").

Based on the facts presented in your letters, and in reliance upon your opinion as counsel, the Division will not recommend any enforcement or administrative action should the transactions proceed as outlined in your letters. So as to avoid unnecessary restatement or summarization of the facts set forth in your letters, the Division's response is attached to a photo copy of your letters.

This response does not purport to express any legal conclusions regarding the applicability of statutory or regulatory provisions of federal or state securities laws to the questions presented. It merely expresses the Division's position on enforcement or other administrative actions.

Inasmuch as this recommendation is based upon the representations made to the Division, it should be noted that any different facts or conditions of a material nature might require a different conclusion. Furthermore, this no-action letter relates only to the referenced issuers and securities and shall have no value for future similar offerings and does not absolve any party involved from complying with the anti-fraud provisions contained in § 61-1-1 of the Act.

Very truly yours,

UTAH DEPARTMENT OF COMMERCE
DIVISION OF SECURITIES

S. Anthony Taggart
Director of Corporate Finance

cc: Mark J. Griffin, Director

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February 7, 1996

Utah Securities Division
Department of Commerce
Heber M. Wells Building
160 East 300 South
Salt Lake City, Utah 84111

Attention: Mr. S. Anthony Taggart, Director of Corporate Finance

Re: Request for Interpretive Response on offering of Earned Membership Units in Physician Management Company of Utah, L.C.

Dear Mr. Taggart:

This letter constitutes a formal request for an interpretive response from the Utah Securities Division (the "Division") to the effect that the earned membership units (an "Earned Membership" or the "Earned Memberships") proposed for sale by Physician Management Company of Utah, L.C. ("PMC"), a limited liability company being organized under the laws of the state of Utah. are not securities, as that term is defined in section 61-1-13(22) of the Utah Uniform Securities Act (the "Act").

Facts

A small group of physicians, under the initiative of Lynn R. Webster, M.D., have determined to undertake the organization of PMC to foster the independence, competitiveness, and financial viability of physicians by offering to Utah physicians contract negotiation and management services. Persons purchasing the services of PMC will acquire an interest in and become a member of PMC. Membership in PMC is currently limited to physicians who are licensed to practice medicine in, and who are residents of, Utah or to physician practice groups composed exclusively of physicians who are licensed to practice in, and who are residents of, Utah. PMC intends to offer Earned Memberships based upon the gross practice revenues of the physicians or practice groups. Initially, PMC will sell to physicians or practice groups at the rate of one Earned Membership for each $200 of actual 1995 or projected 1996 net practice income, as determined in accordance with a recognized medical profession formula, of such physician or practice group at a price of $0.10 per Earned Membership. In other words, a physician with net practice income during 1995 of $250,000 would be entitled to purchase for $125 1,250 Earned Memberships. The amount of net practice income required per Earned Membership may be changed for future members at the discretion of PMC. In addition, in connection with the purchase of an Earned Membership, each purchasing physician or practice group will be required to enter into a PMC services agreement for which a separate service fee is payable.

The $0.10 per unit membership price is intended to be a relatively nominal fixed price in the face of a concern that issuing membership units merely in connection with appointing PMC as contract negotiating representative may be considered income to the recipient. We believe that this potential is substantially reduced by fixing a specific price per unit. In addition, establishment of a fixed purchase price facilitates the mechanics of effecting redemptions in specific circumstances as discussed below.

Under the terms of a PMC services agreement, each member physician or practice group would designate PMC as such member's exclusive representative to provide contract management, cost containment, and quality improvement programs on the member's behalf with hospitals, insurance companies, preferred provider organizations, health maintenance organizations, and other health care providers. As compensation to PMC for providing these services, each member physicians or practice groups would be required to make annual payments to PMC in an amount equal to 1.5% of such member's net practice income, again as determined in accordance with a recognized medical professional formula, but in no event more than $5,000 per year.

As previously stated, purchasers of Earned Memberships are entitled to an ownership interest in PMC, which is to be organized as a Utah limited liability company. As members, physicians or practice groups owning Earned Memberships would be entitled to vote on all matters submitted to the members for consideration, including the election of a board of managers responsible for the management of PMC, after the holders of Purchased Membership Units providing the initial capital to PMC are returned an amount equal to their investment. Notwithstanding the delegation of authority for day-to-day business affairs to the board of managers, a number of specified actions could only be taken on the consent of the holders of a majority of the outstanding membership units in PMC.

The Earned Memberships would be subject to significant restrictions on their transfer. In general, holders will be prohibited from voluntarily transferring Earned Memberships other than back to PMC. PMC's operating agreement will require that a member physician or practice group sell the Earned Memberships back to PMC if such member physician ceases to be licensed to practice medicine in the state of Utah or such practice group ceases to be made up of physicians licensed to practice medicine in the state of Utah. Members are also required to sell Earned Memberships to PMC in certain other limited circumstances. The price at which the Earned Memberships are to be sold back to PMC is fixed at the price at which the Earned Memberships are to be issued ($0.10), unless such Earned Membership has been held for more than 24 months, in which case the price to be paid is equal to the fair market value of the Earned Membership.

In connection with the organization of PMC, its organizers intend to create an incentive plan whereby PMC can grant to its key management as well as members of the board of managers management incentive units representing membership interest in PMC. In addition, in connection with such organization, PMC's founders intend to sell a separate class of units designated as Purchased Membership Units for cash to a limited number of members also holding Earned Memberships, in reliance on limited offering or private placement exemptions from registration under the Act. Persons acquiring Purchased Membership Units will have a preferential right of return on their capital before any distributions are made to any other members, including Earned Memberships. Subject to the preferential return on distributions to the purchasers of Purchased Membership Units, distributions thereafter will be made to the holders of all units regardless of the type held.

It is anticipated that the organizers of PMC will offer Earned Memberships broadly to physicians and physician practice groups throughout Utah, concentrating initially on specific health care markets, practice specialties, and other specific groups. Physicians and practice groups will be solicited by written materials that will emphasize the benefit to be received from improved contract management and cost containment and quality improvement programs. The benefits to physicians will be individual in that they will benefit directly from their own performance under contracts managed by PMC and by their own success in implementing cost containment and quality improvement programs. Although the fees to be collected by PMC for contract management, cost containment, and quality improvement programs may result in the eventual financial success of PMC as an entity, certainly for the foreseeable future, each member physician will benefit principally from the improved contract management, cost containment, and quality improvement programs for his or her own services and not from the potential profitability of PMC as an entity.

At the time of becoming a member of PMC, each physician or physician practice group acquiring Earned Memberships will be required to join in the operating agreement of PMC (the "Operating Agreement") setting forth the participation by members of management of PMC, detailing the restrictions on the transferability of membership interests, and other terms and conditions governing operation of the entity as summarized herein.

Any document evidencing the Earned Memberships will be marked conspicuously on its face noting the restrictions on transfer.

Discussion

Section 61-1-13(22) of the Act defines the term "security" as any " . . . stock; treasury stock; . . . transferable share; investment contract; . . . 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, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing."

The above definition of a security is not materially different from the one contained in Section 2(1) of the Securities Act of 1933 (the "1933 Act"). Accordingly, the Utah courts have relied on federal case law interpreting Section 2(1) of the 1933 Act in order to interpret the term "security" as contained in Section 61-1-13(22) of the Act. *Payable Accounting Corp. v. Utah Securities Commission ex rel. McKinley*, 667 P.2d 15 (Utah 1983). This position is supported by Section 61-1-27 of the Act which provides "This chapter may be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation."

In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975), the U.S. Supreme Court stated:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . .stock." Rather we adhere to the basic principle that has guided the Court's decisions in this area:
>
> > [I]n searching for the meaning and scope of the word "security" in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). *See also Howey, supra,* 328 U.S., at 298 [footnote omitted].

The first question that must be addressed is whether the Earned Memberships are economically equivalent to "stock." In *Landreth Timber Co. v. Landreth*, 471 U.S 681 (1985), the court set forth the following other characteristics as traditionally associated with stock: " . . . (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." (472 U.S. at 686 (*citing United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975)). The following paragraphs illustrate that the Earned Memberships to be offered and sold by PMC are not the equivalent of "stock" for the purposes of applying Section 61-1-13(22)(b) of the Act or Section 2(1) of the 1933 Act because they do not possess the characteristics of stock as identified by *Landreth* court.

First, although holders of Earned Memberships will be entitled to share in the earnings of PMC and eventually may receive distributions of income (dividends) based on their ownership of Earned Memberships, such holders will not have the expectation of deriving substantial income in the form of distributions from their purchase of Earned Memberships as a return on the money paid to purchase Earned Memberships. Holders of Earned Memberships will not be entitled to receive any distributions until persons acquiring Purchased Membership Units have received distributions equal to the amounts such persons paid for Purchased Membership Units.

Second, the Earned Membership interests are not negotiable or freely transferable. The Operating Agreement of PMC provides that a holder may not sell, assign or otherwise transfer (by conveyance, operation of law or otherwise) an Earned Membership except to PMC and on such terms and conditions as the member and PMC shall mutually agree. Further, the price that PMC must pay for the Earned Memberships is fixed at an amount equal to $0.10 or the fair market value of the Earned Membership, depending on the length of time that the Earned Membership has been held.

Third, the Earned Memberships cannot be pledged or hypothecated by the holder. As the Operating Agreement provides that a holder may not sell, assign or otherwise transfer (by conveyance, operation of law or otherwise) the Earned Memberships, it would be impossible for a creditor to foreclose on any interest in the Earned Memberships as such foreclosure would result in a prohibited transfer.

Fourth, although holders of Earned Memberships will eventually be able to vote together with the other members on all matters submitted to the members in proportion to their ownership interest in PMC, they will not be entitled to such voting power until holders of purchased membership units have received distributions from PMC in an amount equal to their capital contributions.

Finally, the members will not have any expectation of profit rights. By profits, the courts have meant either capital appreciation resulting from the development of the initial investment or a participation in earnings resulting from the use of investors' funds. As the Operating Agreement prohibits the transfer of Earned Memberships to any third party except PMC and fixes the price that PMC is required to pay for such purchase ($0.10 or fair market value) for at least 24 months after purchase, the member physician or practice group has no reasonable expectation of deriving profit from appreciation in the value of the Earned Membership.

In summary, the Earned Memberships lack the characteristics identified by the *Landreth* court as being traditionally associated with stock. A purchasing physician or practice group will not acquire Earned

Memberships in order to profit from the holding of such Earned Membership but will acquire Earned Memberships to derive substantial personal benefits from increased contract management, cost containment, and quality improvement services which will help them compete more effectively in the health care market.

Since the Earned Memberships do not fall plainly within the usual concept or definition of "stock," consideration must be given to whether the Earned Memberships would otherwise be deemed "securities" by reason of being "investment contracts" or "instruments commonly known as securities" for purposes of Section 61-1-13(22) of the Act. In *Landreth*, the court suggested that the proper test for determining whether a particular instrument which is not clearly within the definition of "stock" as set forth in Section 2(1) of the 1933 Act or which is otherwise of an unusual nature as an "investment contract" or an "instrument commonly known as a security" is the "economic realities" test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In evaluating the economic realities of a transaction, the test is whether the "scheme involves an investment of money with profits to come solely from the efforts of others." *SEC v. W.J. Howey Co.*, 328 U.S. 293 at 301 (1946). *See also Payable Accounting Corp.*, 667 P.2d 15 at 20.

In a number of no-action letters, the staff of the Securities and Exchange Commission has applied the *Howey* test to transactions similar to the one at issue here and has determined that such transactions do not fall within the definition of a "security." *See Arizona Dental IPA, Ltd.* SEC No-Action Letter (available May 1, 1987); *Northwest Practitioners' Associates, Inc.*, SEC No-Action Letter (available October 16, 1986); *Desert Physician Association, Inc.*, SEC No-Action Letter (available June 23, 1986); *Central Florida Medical Affiliates*, SEC No-Action Letter (available April 22, 1985). These no-action letters delineate the following factors used in the *Howey* test: (1) whether membership is held out as a financial investment; (2) whether members will have the requisite knowledge and expertise to evaluate the risks and merits of memberships; (3) the degree of control members exercise; and (4) whether revenues are based on members' own efforts.

The *Howey* test, as explained by the court in *Forman*, "embodies the essential attributes that run through all of the court's decisions defining a security." 421 U.S. at 852. The appellate courts have modified the fourth leg of the *Howey* test to focus on whether "the effort made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glen W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973); *Lino v. City Investing Co.*, 487 F.2d 689 (3rd Cir. 1973).

Applying the factors of the *Howey* test to the characteristics of the Earned Memberships to be offered and sold by PMC, an Earned Memberships is not an "investment contract" or "other instrument commonly known as a security." The Earned Memberships are evidences of personal service representation and participation, not an investment. While the physicians and practice groups will acquire Earned Memberships in exchange for money, the physicians and practice groups to whom the Earned Memberships will be offered will be informed not to expect, and will not have any reasonable expectation of deriving, profits from the ownership of the Earned Memberships.

The fact that purchase price that PMC must pay under the Operating Agreement to repurchase the Earned Memberships is fixed during the first two years of ownership at the price paid by the member and thereafter at fair market value makes any realization of capital appreciation too speculative and insubstantial to create in the mind of any reasonable purchaser an expectation of profit in the sense found necessary in *Howey*. Purchasers will not be attracted to PMC because of financial returns on the purchase of their Earned

Memberships. Rather they will purchase due to the prospect of being members of a physician organization that will provide contract management, cost containment, and quality improvement programs. Accordingly, a member physician or practice group will possess the requisite knowledge and expertise to evaluate the risks and merits of membership in PMC. PMC members will exercise voting control over PMC.

Finally, any revenues or profits of the member physicians or practice groups will not be derived solely or even substantially from the efforts of PMC and its management, but rather from the quality and frequency of the direct provision of medical services by the physicians themselves. The health care service contracts and other arrangements entered into by PMC will all be based economically on the personal professional services provided by member physicians or practice groups, whether those services are paid for on a fee-for-service, capitated, or other basis. In *Forman*, the court explained that when a purchaser is motivated by a desire to use or consume the item purchased, the securities laws do not apply. *Forman*, 421 U.S. at 582. Member physicians or practice groups of PMC are similar to the cooperative housing common stock purchasers in *Forman* in that their purchase is motivated by a desire to use or consume the item purchased. Member physicians or practice groups will use PMC as a means of increasing their own business. The "undeniably significant" effort in producing a member physicians or practice group's "profit" will be the effort of that individual member through the practice of medicine in substantially the same manner as before joining PMC. Member physicians or practice groups will obtain benefit by virtue of providing services pursuant to agreements negotiated by PMC, not by any economic interest in PMC in the form of a Earned Membership. Where an enterprise merely allows a professional person to enhance his or her ability to earn income in the practice of his or her profession, the relationship avoids the fourth leg of the *Howey* test, thus making the interest under consideration not a "security" within the meaning of the securities laws. *IPA of Richmond County, Inc.*, SEC No-Action Letter (available November 17, 1986); *Bronx Cross County Medical Group, P.C.*, SEC No-Action Letter (available August 18, 1989); *Queens-Long Island Medical Group, P.C.*, SEC No-Action Letter (available November 6, 1990). Accordingly, the Earned Memberships are not "securities" under the *Howey* analysis.

The foregoing "common enterprise" analysis is based on the concept of horizontal commonality where multiple investors pool their investments and receive pro rata profits. *See Wals v. Fox Hill Development Corp.*, ¶ 98,085, p. 98,713 (D.C.E.D. Wisc. 1993). Some courts will also allow vertical commonality to satisfy the "common enterprise" prong of the *Howey* test. Vertical commonality exists where the profits and losses of the investor and the promoter are interdependent. (*See Wals*, at p. 98,714.) Although it does not appear that the vertical commonality analysis is recognized in the Utah courts, if such an analysis were used here, again, a common enterprise would not be found. The individual member physicians or practice group will realize little if any financial reward from his or her membership in PMC if he or she is not individually a successful medical practitioner. The organizers and managers of PMC could be successful in providing an environment in which success could be obtained and yet any one member physicians or practice group could fail due to his or her individual efforts. It is clear, therefore, that profits and losses of PMC and the individual member physicians or practice group are not interdependent.

As a general public policy matter, it is noteworthy that the Commission as well as a number of states now have analyzed the legal and practical circumstances surrounding physicians' organizations and with a relatively uniform approach have determined that their organization and operation are unique and outside the parameters of the commercial areas that the securities laws were intended to regulate. The letters cited above support this generalization.

On the basis of the above-stated facts and legal analysis, we request an interpretive response from the Division to the effect that the Earned Memberships of PMC do not constitute "securities" under the definition of that term under the Act.

Very truly yours,

KRUSE, LANDA & MAYCOCK, L.L.C.

James R. Kruse

JRK:sp

cc: Lynn R. Webster, M.D.