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October 3, 1997

I. Douglas Dunipace, Esq.
Jennings, Strouss & Salmon, P.L.C.
One Renaissance Square
Two North Central Avenue
Phoenix, Arizona 85004-2393

RE: 21st Century Pay Communications, Inc. 44-1801 (22)

Dear Mr. Dunipace:

The Securities Division has reviewed your "no-action" request dated July 31, 1997 and your supplemental letter dated September 15, 1997. At this time, the Division declines to take any position on your request.

Very truly yours,

Michael G. Burton, Sr.

MICHAEL G. BURTON, SR.
Director of Securities

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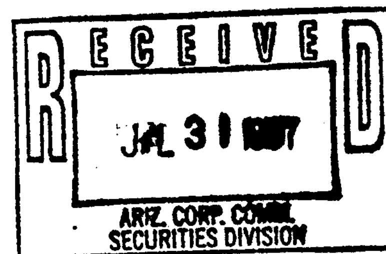

July 31, 1997

Leslie Block, Associate General Counsel
Securities Division
Arizona Corporation Commission
1300 West Washington, 3rd Floor
Phoenix, Arizona 85007

Re: Request for No Action Letter

Dear Leslie:

I am submitting this letter requesting that the staff of the Securities Division (the "Division") concur with our opinions that our client 21st Century Pay Communications, Inc., (the "Company"), may engage in the sale of pay telephones to residents of Arizona without the necessity of registration under the Arizona Securities Act. It is our opinion, as discussed more extensively in the body of this letter, that the proposed activities of the Company in Arizona do not constitute the offer or sale of securities.

Factual Background

The Company is a California corporation with principal offices in Lodi, California. It was organized in 1997 and its business has been conducted primarily in California. It has recently expanded operations to Oregon and would like to enter the Arizona market in the near future. While the Company is relatively new, senior management of the Company has approximately 12 years of substantial experience in the private pay telephone industry.

The Company sells pay telephones that are installed in public places such as restaurants, hotels, malls, hospitals, and transportation terminals. The Company offers standard pay telephones and telephones which have been modified for handicap usage. The Company acquires the telephones from various sources, reconditions them if they are not new, modifies them for handicap use when appropriate, and resells them to persons who may purchase one or more telephones. As of June 30, 1997, the Company had sold 37 telephones in 2 California markets. As indicated by the enclosed copy of page 2363 of the 1997-98 U.S. West Direct

yellow pages for metropolitan Phoenix, a number of other companies already are engaged in essentially the same business here already. (See Enclosure A).

At the present time, the Company charges $7,000 for a standard telephone and $7,500 for a modified telephone. Those prices are, of course, subject to adjustment in the future to reflect competitive forces and the cost of doing business. The purchase price includes a public pay telephone with protective enclosure, pay telephone management software, and, in most instances, assignment of a leased location for the telephone from the Company to the purchaser. The actual selection for the telephone location is the responsibility of the purchaser and the purchaser is not required to place the telephone at any of the locations available through the Company. There is an advantage to the purchaser in utilizing a location acquired through the Company because the Company can usually provide the historical financial information about the location. While the Company cannot guarantee comparable future activity at the location, the information does give the purchaser some idea of what to expect by way of revenue. This assists the prospective purchaser in evaluating the economics of locating the telephone there. Enclosed with this letter is a sample of the Telephone Equipment Sales Agreement currently utilized by the Company in California. (See Enclosure B)

The Company does not maintain a sales force, but uses the services of independent sales companies. At the present time, it has engaged Partners Investment Network ("PIN") in this role.

The Company does not install the telephones. The purchaser may do so or may hire a professional installation company for that task. The Company maintains a list of such professional installation companies in each market where it sells telephones but it is not affiliated with those companies nor does is receive any compensation with respect to the installation of the telephones. Names of telephone installation companies may also be obtained from a telephone directory. (See Enclosure A).

The Company is not involved in the maintenance or servicing of the telephone. In addition to mechanical servicing, telephone servicing includes such matters as periodic collection of the coin revenues in the telephone and paying vendors and lessors, all of which are essentially administrative or ministerial functions. Some telephone purchasers elect to perform these functions themselves. Others hire a separate service company and pay it a fee for providing various of these services. The Company is not affiliated with any of these service companies but does provide a list of such companies in each market where it sells telephones. This list does not purport to give the name of every telephone service company in the market but does provide the names of organizations the Company believes are able to provide appropriate telephone service. Again, a purchaser can identify

telephone service companies by looking in the telephone directory yellow pages. (See Enclosure A).

Enclosed with the letter are representative sample service agreements which the Company has collected in various markets. (See Enclosure C). These service agreements allow the owner of the pay telephone to select various levels of service depending on the degree to which the owner intends to be involved in the day to day management of his or her pay telephone. Many service companies do not have prepared form agreements but customize the terms of the arrangement depending upon the needs and desires of the telephone owner. Typically these service agreements are for a period of one or more years after which they expire unless renewed by agreement of both the telephone owner and the service company. Most also allow the owner to terminate the service company upon several days notice. The Company is aware that a few of the service companies also offer to purchase the telephone from the owner at the end of the service term. That arrangement is, however, between the service company and the owner and does not involve the Company.

The Company sells the telephones to persons who reside in the area where the telephones are to be located, not in some distant city. The Company makes it clear to each telephone purchaser that realizing a profit from public pay telephone ownership requires involvement of the owner. Even if a service company is utilized to carry out some of the tasks of servicing the telephones, the owner needs to stay involved. The ultimate decision on the degree of involvement rests with the purchaser. The telephones are not sold as a tax shelter but a business opportunity for the purchaser.

While a purchaser may acquire more than one telephone, each telephone is a separate economic unit. The revenues and profits of one owner are not shared or pooled with those of any other owner. Nor does the owner pay anything to the Company once the telephone is purchased. This is an outright sale and not a sale-leaseback or other arrangement creating an ongoing economic link between the Company and a purchaser.

Discussion of Applicable Law

Definition of Security.

The Arizona definition of a "security" is found in Arizona Revised Statutes ("ARS") Section 44-1801, as follows:

§ 44-1801. Definitions

In this chapter, unless the context otherwise requires:

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23. "Security" means any note, stock, treasury stock, bond, commodity investment contract, commodity option, 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, factional undivided interest in oil, gas or other mineral rights, real property 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, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

In most respects, this language is virtually identical to the definition of "security" found in Section 2 of the federal Securities Act of 1933. As a consequence, Arizona has given great deference to federal interpretations of securities laws for guidance. First Federal Savings & Loan Association v. Worthen Bank & Trust Co., 919 F.2d 510 (9th Cir. 1990). As a consequence, in discussing the issues presented here, I will refer to both Arizona and federal law precedent.

It is clear that most of the instruments or interests described in the definition of "security" are inapplicable to the present facts. However, in view of the broad interpretation sometimes given to the concept of an "investment contract," this letter is being submitted for consideration and response by the Division.

Definition of Investment Contract.

There is no statutory definition of an "investment contract" but both Arizona and federal courts have had occasion to attempt to define that term in a number of factual contexts, none of which are substantially similar to the facts presented by the Company. In fact, my research has disclosed no reported cases in which the sale of pay telephones was involved. Therefore, it will be necessary to examine cases most closely analogous to the present facts in determining whether the activities of the Company may constitute the offer and sale of a security in the nature of an "investment contract."

Arizona courts have defined an "investment contract" to be a transaction in which an individual is led to invest money in a common enterprise with expectation that he will earn profits solely through the efforts of others, as characterized at the time the transaction occurred. See, Daggett v. Jackie Fine Arts, Inc., 152 Ariz. 159, 733 P.2d 1142 (App. 1986). The critical elements are (i) an investment of money,

(ii) a common enterprise, and (iii) expectation of profits solely through the essential entrepreneurial and management efforts of others. This approach is very similar to federal cases. See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293, 66 Sup.Ct 1100, 90 L.Ed 1244 (1946). An analysis of each of those elements follows. In so doing, I will focus on cases in which the purchase of tangible personal property is an essential element of the transaction.

(i) **Investment of Money.** There is no question that a person buying a pay telephone from the Company is investing money in the form of the purchase price for the telephone. Therefore, the discussion will need to focus on the second and third elements of the so called Howey test as applied in Arizona.

(ii) **Common Enterprise.** In determining whether a "common enterprise" is present, courts have looked at both "horizontal" commonality and "vertical" commonality. Horizontal commonality means that the fortunes of individual investors are tied to the fortunes of other investors through the pooling of assets, usually accompanied by a pro-rata sharing of profits so that the fortunes of each investor depends upon the profitability of the enterprise as a whole as managed by the promoter or a third party. See, Revak v. SEC Realty Corp., 18 F.3d 81 (2nd Cir. 1994). Vertical commonality, on the other hand, focuses on the relationship between the promoter and the body of investors. It requires a positive correlation between the success of the investor and the success of the promoter, without requiring a pooling of funds. See, Brodt v. Bache & Co., 595 F 2d 459 (9th Cir. 1978).

Arizona has thus far failed to select one approach or the other. In Rose v. Dobras, 128 Ariz. 209, 624 P.2d 887 (App. 1981), the Court of Appeals determined that both commonality tests were met so that it was not necessary to determine if Arizona would adopt one test over the other. In Daggett v. Jackie Fine Arts, Inc., supra, a different division of the Court of Appeals indicated that satisfaction of either test would meet the requirements of the "common enterprise" element of the Howey test.

(a) Horizontal Commonality. Clearly, the proposed activities of the Company do not create a situation in which there is horizontal commonality. The pay telephones are sold to individual purchasers for separate locations. There is no pooling of funds, the profitability of one owner's pay telephone locations is not tied to or in any way dependent on the profitability of other locations owned by other persons. The purchasers of the pay telephones will not share profits with any other telephone purchasers. See, Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144 (7th Cir. 1984)

(b) Vertical Commonality. Vertical commonality is also absent from the fact setting described in this letter. The fortunes of the purchasers are not

tied to the fortunes of the Company. Once the telephone is sold, the Company has received everything that it will get from the transaction. The Company could go out of business (which it does not intend to do) and the purchaser will still own the telephone and be able to continue in business. The purchaser's telephone business does not share in any of the profits of the Company and the Company certainly does not share in any of the revenues or profits realized by the purchaser. See, Stenger v. R.H. Love Galleries, Inc., supra.

(iii) **Profits Solely Through the Entrepreneurial and Management Efforts of Others.** The pay telephones are not marketed as a "passive investment." It is made clear to each potential purchaser that the ownership and operation of the pay telephone locations will require regular attention. The purchaser has the absolute right to handle all the details of the pay telephone business himself or he may determine on his own whether to engage other persons to assist. In either event, the Company is out of the picture once the telephone is purchased.

The Company has recognized that a person who enters the pay telephone business may not want to handle all the details of the business personally. That person may engage individuals or companies, not affiliated with the Company, to assist in the business. If a person owns a significant number of telephones, it may make sense to hire one or more employees to work in the business. On the other hand, if that is not desired, the telephone owner may engage outside companies to handle some of the periodic tasks inherent in the business. Because the private ownership of public pay telephones has become such a significant industry, there are service companies who offer to handle these chores for a fee. However, in each instance, the decision on who to engage, whether to change service companies, and the degree to which such companies will be utilized is solely in the hands of the telephone owner. The Company has no interest in or control over those decisions.

The factual pattern described in this letter simply does not support a conclusion that the profits to be derived by a telephone purchaser are dependent on the entrepreneurial or management efforts of the Company or others.

Discussion of Cases.

As stated above, there are very few cases from which any analogies may be drawn to the facts outlined in this letter. Those cases that are reported involve tangible personal property than pay telephones and also involve factors which are not present here. A brief review of those cases will demonstrate the point.

(i) **Arizona Cases.** I am aware of only three reported Arizona cases in which there was a sale of a tangible product and an assertion that a "security" in the form of an "investment contract" was involved. Two of those cases, Sullivan v. Metro Productions, Inc., 150 Ariz. 573, 724 P.2d 1242 (App. 1986), and Vairo v.

Clayden, 153 Ariz. 13, 734 P.2d 110 (App. 1987), involved the sale of master videotapes. The third case is Daggett v. Jackie Find Arts, Inc., supra, which involved the sale of an art master.

In Sullivan, the Court of Appeals concluded that the sale of videotape masters constituted the sale of a security. The factors on which the court relied in reaching this result include the following, all of which are absent in the present factual setting: (i) the investment was offered as a tax shelter; (ii) the purchaser made only a small down payment with the balance, represented by a non-recourse promissory note, to be realized from the distribution of the video; (iii) the purchaser was contractually required to hire a management consulting firm to assist in the distribution; (iv) all of the purchasers ended up using the same management consulting firm; (v) the master videotape was not delivered to the purchaser but was kept in a vault with the promoter until the promissory note was fully paid; and (vi) all payments received from distribution of the video were required to be paid directly to the promoter, not to the purchaser. The court observed that the only way the promoter could be fully paid was if the distribution of videos by the purchaser generated money to pay the non-recourse promissory note, thereby creating horizontal commonality. Additionally, the only way the purchaser could successfully distribute the videos was through the management consulting firm, thereby creating total reliance on others for the success of the investment. Neither of these elements is present with respect to the sale of public pay telephones by the Company.

In Jackie Fine Arts, the Court of Appeals concluded that the sale of an art master constituted the sale of a security. The factors on which the court relied in reaching this result include the following, all of which are absent in the present factual setting: (i) the investment was offered as a tax shelter; (ii) the purchaser made only a small down payment with the balance, represented by non-recourse and partially non-recourse promissory notes, to be realized from the sale of prints made from the art master; (iii) the promoter "strongly suggested" that the purchaser employ an experienced art distributor and not try to distribute prints on his own; (iv) the promoter characterized the purchase of the art master as an investment, not a business: (v) the promoter in fact made all the production and printing arrangements for the limited edition of prints; and (vi) the promoter promised to provide tax assistance is the IRS challenged the purchaser's tax treatment of the transaction. Again, the court observed that the only way the promoter could be fully paid was if the sale of prints by the purchaser generated money to pay the non-recourse promissory note and the non-recourse portion of the other promissory note, thereby creating horizontal commonality. The promoter also retained ongoing obligations to the purchaser by virtue of the tax defense undertaking. Additionally, the promoter indicated that the only way the purchaser was likely to be successful was through the use of a professional distributor, thereby creating substantial reliance on others for the success of the investment. Again, none of these elements

is present with respect to the business of the Company. Interestingly, in Faircloth v. Jackie Fine Arts, Inc., 682 F.Supp 837 (D. S.C. 1988), the United States District Court in South Carolina determined that the Jackie Fine Arts art master program did not involve the sale of a security under either federal or South Carolina law.

In Vairo, the Court of Appeals reversed a summary judgment with respect to another master videotape transaction on the basis that there were disputed facts and certain undisputed facts were different than in Sullivan or Jackie Fine Arts. Of particular importance was the fact that the promissory notes given by the purchaser in Vairo were full recourse, rather than non-recourse, so that the payment of the promoter by the purchaser was not tied to the purchaser's success in distributing the master videotape programs. With respect to the Company here, not only is there no non-recourse financing, there is no financing at all. The full purchase price is paid up front and the Company has no further dealings with the purchaser.

The relationship found to be a security in each of the Arizona cases is readily distinguishable from the Company's activities.

(ii) **Other Cases.** As stated above, there are not many reported cases which deal with the sale of tangible personal property. Many of them involve a sale and leaseback which is not the situation here. See, e.g., In re Professional Financial Management, Ltd., 692 F.Supp 1057 (D. Minn. 1988) (energy conservation devices); Albanese v. Florida National Bank of Orlando, 823 F.2d 408 (11th Cir. 1987) (ice machines); and United States v. Jones, 712 F.2d 1316 (9th Cir. 1983) (truck trailers). The Company does not engage in any sale and leaseback arrangement nor has it arranged with any third party to lease the telephones it sells to purchasers. The transaction is strictly a sale.

Others involve live animals which is clearly not the Company's situation. See, e.g. Ahrens v. American-Canadian Beaver Co. Inc., 428 F.2d 926 (10th Cir. 1970) (beavers); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) (chinchillas); Smith v. Gross, 604 F.2d 639 (9th Cir. 1979) (earthworms); and Waterman v. Alta Verde Industries, Inc., 643 F. Supp 797 (E.D. N.C. 1986) (cattle). These cases all turn primarily either on the absolute necessity of using the promoter to raise the animals or the essential role of the promoter in providing a market for the mature animals, or both. Neither of those elements is present with the pay telephones as explained in the factual description above.

In the art arena such as was involved in the Jackie Fine Arts case in Arizona, the only two other cases I have identified both conclude that the sale of art, even with certain accompanying management or distribution agreements, did not involve the sale of a security. See, Faircloth v. Jackie Fine Arts, Inc., supra, and Stenger v. R.H. Love Galleries, Inc., supra. In Stenger, there is even an agreement

by the seller to give the buyer full credit for the original purchase price of the art in connection with an exchange of that art for other art.

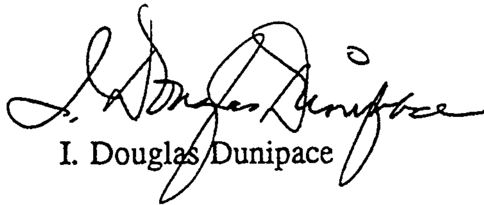
Conclusion

We are of the opinion that the Company's proposed activities in Arizona, as set forth in this letter, do not constitute the offer and sale of a security both because there is no "common enterprise" and because the telephone purchaser will not be relying on any essential entrepreneurial or management efforts of the Company of others. We are requesting that the Division concur in our opinions and analyses set forth in this letter and confirm that you will neither take nor recommend any enforcement action against the Company if it offers and sells pay telephones in Arizona as described above.

Enclosed with this letter is a check for $200.00 representing the Division's fee for considering this request. Should you wish to discuss this letter prior to issuing your response or if you need additional information, please contact me at the address or telephone number indicated at the top of this letter. If you believe a conference with you or other members of the staff would be useful, both our client and I will make ourselves available.

Very truly yours,

JENNINGS, STROUSS & SALMON, P.L.C.

By 
I. Douglas Dunipace

IDD\paj

xc: William Yotty, 21st Century Pay Communications, Inc.