Statute File

ARIZONA CORPORATION COMMISSION

SECURITIES DIVISION
(602) 542-4242
(602) 255-2600
FAX: (602) 255-2617

February 2, 1993

James F. Kahn, Esq.
Kahn & Freeman, P.A.
4150 North 12th Street
Phoenix, AZ 85014

RE: Villa Lafayette Associates, Inc./ No-Action Request
A.R.S. §§ 44-1801(22), and 44-1844(A)(1)

Dear Mr. Kahn:

After reviewing your above-referenced no-action request, the Securities Division is unable to concur with your conclusion that the promissory notes to be issued by Villa Lafayette Associates, Inc. (the "Association") will not constitute "securities" for purposes of A.R.S. §44-1801(22). The Division's position remains that such notes constitute securities and require registration.

However, it appears that the proposed transaction meets the requirements of A.R.S. § 44-1844(A)(1), exempting transactions by an issuer not involving any public offering. When conducting an analysis of that section, the Division looks for guidance from Federal court decisions interpreting § 4(2) of the Securities Act of 1933. The threshold question in those decisions is whether the particular class of persons affected needs the protection of the 1933 Securities Act registration provisions? In answering this question, the federal courts have employed the following factors as guideposts:

- the number of offerees
- the sophistication of the offerees
- the number of units offered
- the size of the offering
- the manner of the offering
- the relationship of the offerees to the issuer

Although no one factor is determinative in the analysis, the courts appear to give the greatest weight to the last factor, the relationship between the offerees and the issuer. If, after reviewing these factors, the answer to the threshold question is determined to be no, a private offering exemption is found to exist under § 4(2).

On the basis of the facts set forth in your letter of January 8, 1993, and Mr. Larabell's letter of December 29, 1992, and on oral representations made by you and by Mr. Larabell on the

telephone, the factors in a § 4(2) analysis as applied to the instant case are as follows:

- **number of offerees:** The small number of offerees (10 to 15) weighs in favor of the Association.

- **the sophistication of the offerees:** The Association is comprised of its members, who are invited and encouraged to take an active role in the operations of the Association. All members have, or are entitled to have access to information as to how funds will be used, and to the Association's financial statements. Operating budgets are circulated to the membership and approved at open meetings of the memberships. This factor weighs in favor of the Association, as the offerees are well-positioned to evaluate the merits and risks of this investment.

- **the number of units offered:** The small number of units (15 at $5,000 each) weighs in favor of the Association.

- **the size of the offering:** The small size of the offering ($75,000) weighs in favor of the Association.

- **the manner of the offering:** The offering will be conducted through personal contacts, and no advertising. This factor weighs in favor of the Association.

- **the relationship to the issuer:** As members of the Association, all offerees have, or are entitled to have access to information about the Association which will enable them to make an informed investment decision. The privileged status of the offerees causes this factor to weigh in favor of the Association.

As all of the factors in the § 4(2) analysis may be weighed in favor of the Association, the threshold question must be answered no, the particular class of persons affected does not need the protection of the 1933 Securities Act registration provisions. Therefore, based upon your letter and Mr. Larabell's letter, upon the oral representations made by you and Mr. Larabell on the telephone, and in reliance upon your opinion as counsel, the Securities Division will not recommend enforcement action for violation of the Securities Act of Arizona should the transaction take place as set forth by you and your client.

As this position is premised upon the facts set forth by you and your client, it should not be relied on for any other set of facts or by any other person. Please also note that this position applies only to the registration requirements of the Act; the anti-fraud provisions of the Act continue to be applicable.

We have attached a photocopy of your letter and of Mr. Larabell's letter. By doing this we are able to avoid having to recite or summarize the facts set forth therein.

Very truly yours,

DEE RIDDELL HARRIS
Director of Securities

DRH:JB

Attachments

cc: Mr. Robert A. Larabell, President
Villa Lafayette Associates, Inc.
4727 East Lafayette Blvd.
Phoenix, AZ 85018

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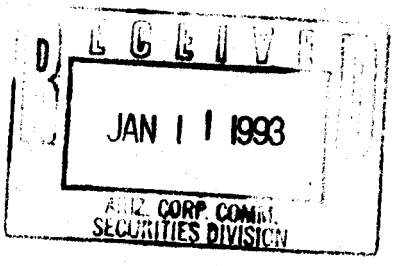
January 8, 1993



FACSIMILE TRANSMISSION AND
FIRST CLASS MAIL

Ms. Jean Berry
Securities Division
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Re: Request of Villa Lafayette Associates, Inc.
for "No Action Letter"
Our File No. 171.00

Dear Ms. Berry:

I.

INTRODUCTION

This letter is written as a supplement to the December 29, 1992, request of Villa Lafayette Associates, Inc. for a "no-action" letter.

You have indicated that it is beneficial to the Division to have a legal analysis in support of the request for a "no-action" letter.

As reflected in the December 29th letter from Villa Lafayette, the transaction under consideration is a tremendously simple and straight-forward transaction. Villa Lafayette is a non-profit homeowners association incorporated in the State of Arizona. It seeks to borrow money exclusively from several of its own members. (It was originally anticipated that the number would not exceed 15 members. The loans to the corporation from its members will be documented with a simple promissory note bearing a fixed rate of interest at 10 percent per annum. The notes will be retired through equal quarterly payments of interest and principal over a period of 60 months, or less.

II.

THE NOTES ARE NOT "SECURITIES"

Securities are defined in A.R.S. § 44-1801.22. The bare language of that section purports to include notes and other evidences of indebtedness. The definition of "security" in Arizona is patterned after and virtually identical to the Federal statutory definition. Arizona looks to Federal interpretation of securities law for guidance. (*First Citizens Federal Sav. & Loan Ass'n v. Worthen Bank and Trust Co.*, N.A., C.A. 9 (Ariz.) 1990, 919 F.2d 510).

The U.S. Supreme Court has addressed the issue of whether promissory notes are "securities" within the framework of § 3(a)(10) of the Securities Exchange Act of 1934, after which the Arizona statute is patterned and which, for purposes of this particular issue, is virtually identical to the Arizona statute.

In *Reves v. Ernst & Young*, 494 U.S. 56, 110 S.Ct. 945 (1990), the Court stated:

> " . . . the phrase "any note" should not be interpreted to mean literally "any note," but must be understood against the backdrop of what Congress is attempting to accomplish in enacting the Securities Acts."

The Court reaffirms its own prior holding wherein it said "'note' may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context." (Citation omitted) The *Reves* Court adopts the "family resemblance" test for analyzing whether an instrument is a security. The Court adopted four factors for determining the applicability of the statutory definition to the transaction:

1. First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate,

the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."

2. Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment."

3. Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.

4. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary. (Citations omitted)

In applying the recited factors to the instant case, we find:

First, that the notes are being used to facilitate the purchase of a minor asset or consumer good, specifically an air-conditioning system and to assist Villa Lafayette's cash flow by reducing the overall cost of this transaction for the benefit of all members of the Association.

Second, the plan of distribution is substantially contrary to the plan in *Reves*. In *Reves*, the borrower offered the notes over an extended period of time to 23,000 members as well as to non-members. More than 1,600 people held the notes at the time that the notemaker filed for bankruptcy. Here, the notes are being offered only to 10-15 members of the Association. There are a total of 90 homeowners in the Association. The total market value of the members' interests in Villa Lafayette would approximate $5-6 million dollars depending on market

values. The central air conditioning unit will cost approximately $75,000; a relatively insignificant sum when related to the value of the entire facility.

Third, the "reasonable expectations of the investing public" is extremely limited. Each of the members of the Association is invited and encouraged to take an active role in the operations of their Association and indeed to serve on the Board of the Association. The Association is totally self-managed by its membership. Operating budgets are circulated to the membership and approved at open meetings of the membership. The budget is created on a cost of operations and anticipated reserves basis, not relying upon the profitability of sales of product or effectiveness of a sales force. Repayment of the note is scheduled pursuant to the budget and according to the rights of the Association to assess its members on an annualized basis. Members who fail to pay their annual fees are subject to liens and legal action. Typically, fewer than one or two defaults per year occur requiring the Association to exercise its lien rights.

Fourth, the Court looks to some factors (such as the existence of another regulatory scheme) significantly reducing the risk of the instrument, thereby rendering application of the Securities Acts unnecessary. The factors discussed in the prior paragraph provide the scheme of protection and, frankly, better protection throughout the life of the transaction than is obtained by a disclosure statement (published and applicable only at the inception of the relationship.

In summary, the purpose of the transaction is to facilitate the acquisition of a specific piece of equipment to be used in a consumer context and for the benefit of the lenders as well as the other members of the Association. The Association is a non-profit Association of members owned and operated by its members for the sole and exclusive benefit of its members. Only a small number of members will participate in the program and those members have, or are entitled to have, an intimate awareness of the operations of their own Association. The expectations of those willing to lend money is directly based upon the fixed rate of interest and the operating budget of their organization. There is no speculation involved and relatively little reliance on management expertise in the context in which typical securities are marketed. Because of the intimate involvement of the members in their own organization, the risk of a major loss is subject to frequent review and scrutiny and even control of those who would lend money to their Association.

We respectfully submit that the lending arrangement described in the December 29th request and above are not securities as defined and therefore should not be subject to the Securities Laws and Regulations.

III.

SUMMARY

Villa Lafayette respectfully requests that the Securities Division of the Corporation Commission determine that this transaction does not involve "securities" as defined and therefore that it will issue its "no-action" letter.

If any further information is needed, please don't hesitate to advise.

Very truly yours,

KAHN & FREEMAN, P.A.

James F. Kahn

JFK/mls
(JFK\17100.1)

cc: Client

Villa Lafayette Associates
4727 E. Lafayette Blvd. Phoenix, Arizona 85018

December 29, 1992

Ms Jean Berry
Securities Division
ARIZONA CORPORATION COMMISSION
1200 W. Washington St.
Phoenix, Arizona 85007

Re: Request for "No-Action Letter" or Exempt Status

Dear Ms Berry:

In accordance with Arizona Administration Code, Title 14, Chapter 4, we are applying for Exempt Transaction Securities status for loans totaling $75,000.00.

Villa Lafayette Associates, Inc. is a non-profit homeowners association incorporated in the State of Arizona in 1974. Its legally defined members are the owners of condominium units in Villa Lafayette.

Villa Lafayette has determined that it needs to replace its central air-conditioning plant at a cost of approximately $75,000.00. Several members of the corporation have offered to lend portions of the money needed at a rate far more advantageous to the Association than is available through the equipment vendor. The loans would be documented by one or more promissory notes bearing interest at the rate of ten percent (10%) per annum, simple interest. The notes would be retired through quarterly payments of prinicipal and interest in five years or sooner.

The details of the Association's long-range funding program, its capital improvement needs, and its funding options are fully set forth in its December 1992 Newsletter and the Supplement to that newsletter, copies of which are attached.

The Villa Lafayette annual operating budget for fiscal year beginning October 1, 1992, is also attached.

These attachments outline the various financing approaches which the Board of Directors has considered. We prefer borrowing the funds from our members, not only because of the cost savings and elimination of inequitable personal burdens on Board members, but equally important, because of the direct involvement of Members in our financial program and the resultant personal return to those who are willing to loan money to the Association. Villa Lafayette has no indebtedness, has never defaulted on a loan or even overdrawn its checking account in eighteen years, and has never been sued nor have we sued others, except for occasional liens upon delinquent members. Also enclosed is a copy of our most recent audited annual financial report.

No commission or remuneration of any kind shall be paid, directly or indirectly, by Villa Lafayette to any person in connection with the distribution or sale of these promissory notes.

Villa Lafayette Associates

4727 East Lafayette Blvd. Phoenix, Arizona 85018

Ms Jean Berry
Securities Division
ARIZONA CORPORATION COMMISSION
December 29, 1992
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We understand that the Securities Division has a "no-action letter" program. Due to the nature of our organization, we believe that, at least by analogy, we would be entitled to exemption status under A.R.S. Sec. 44-1843(A)(6).

In the alternative, as we understand Title 14, Chapter 4, we believe that we qualify for exempt transaction securities, as defined under Sections R 14.4.101 or R 14.4.102, or both. Please do not hesitate to contact the writer at the above address, unit 329, (602) 840-1803, or James Kahn of Kahn & Freeman, P.A., 4150 North 12th Street, Phoenix, Arizona 85014, (602) 266-1717, if you have questions on this petition, or if additional information is needed.

Sincerely,

Robert A. Larabell

Robert A. Larabell, president
VILLA LAFAYETTE ASSOCIATES

12-29-92
my commission expires
7/2/94
Shirley J. Smith

Receipt of the foregoing Notice of Intention to Sell Securities is acknowledged as of the date indicated. The Commission enters no objection to the offering described therein, and such offering may be commenced _____, 19___.

ARIZONA CORPORATION COMMISSION
Securities Division

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