

State of Utah  
DEPARTMENT OF COMMERCE  
DIVISION OF SECURITIES

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April 14, 1994

Mr. James R. Kruse  
Kruse, Landa & Maycock  
Eighth Floor, Bank One Tower  
50 West Broadway  
Salt Lake City, Utah 84101

Re: Quality Physicians Network, Inc. File #003-1168-35/A21801-35

Dear Mr. Kruse:

This letter is in response to your letter dated March 31, 1994, requesting that the Division issue an interpretive opinion to the effect that Memberships of Quality Physicians Network, Inc. do not constitute "securities" as that term is defined in the Utah Uniform Securities Act ("Act"). Your letter was filed in conjunction with a previous filing made pursuant to § 61-1-25(5) of the Act, and Division Rule R164-25-5 on behalf of Quality Physicians Network, Inc.

So as to avoid unnecessary restatement or summarization of the facts set forth in your letter, the Division's response is attached to a photo copy of your letter.

Based upon your factual representations and legal analysis, the Division is of the opinion that Memberships of Quality Physicians Network, Inc. do not constitute "securities" as that term is defined in the Utah Uniform Securities Act, as amended.

Because this opinion 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. Please note that this opinion relates only to the referenced memberships and shall have no value for future similar factual circumstances.

Very truly yours,

MARK J. GRIFFIN, DIRECTOR  
UTAH DIVISION OF SECURITIES

  
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Assistant Director

jmj

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March 31, 1994

State of Utah Securities Division  
Department of Commerce  
160 East 300 South  
Salt Lake City, Utah 84111

Attention: Matt Jenkins, Exemption Specialist

Re: *Request for Interpretive Response on Organization  
of Quality Physicians Network, Inc. a Utah corporation*

Dear Mr. Jenkins:

On January 14, 1994, Quality Physicians Network, Inc. ("Quality") submitted to the Utah Securities Division (the "Division") a request for a no-action letter respecting the issuance of "stock" in connection with Quality's organization. It is our understanding that the provisions of Rule R164-25-5 under the Utah Uniform Securities Act (the "Act") were complied with in connection with that request, including the payment of the appropriate fee. The earlier correspondence included copies of preliminary forms of a "Participating Physician Agreement," "Subscription Agreement," and "Shareholder Agreement," all of which should be considered in connection with this request. This firm has been engaged by Quality to pursue that request on its behalf.

A review of the correspondence between the Utah Securities Division (the "Division") and Quality indicates that the Division was considering a no-action position that would be conditional on Quality making the type of disclosure to offerees and purchasers that would be required in a registration statement for the offer and sale of securities. Taking a somewhat different approach, we believe that the voting rights and ownership interests in Quality evidenced by memberships (a "Membership" or the "Memberships") proposed for sale by Quality are not securities as that term is defined in Section 61-1-13(22) of the Act. Therefore, we are requesting on behalf of Quality that the Division issue an interpretive opinion to the effect that Memberships of Quality do not constitute "securities" as that term is defined in the Act

**FACTS**

On January 13, 1994, the organizers of Quality filed Articles of Incorporation with the Utah Division of Corporations and Commercial Code of the Department of Commerce incorporating Quality. The initial articles of incorporation provided for authorized capitalization of 1,000 common voting shares. In order to avoid the use of "stock" and "share" terminology for the reasons set forth below, Quality proposes to amend its articles of incorporation to provide that voting rights and ownership interests in Quality will be evidenced by Memberships. Appropriate changes will be made to the Participating Physician Agreement, Subscription Agreement, and Shareholder Agreement to conform to the revised terminology. Therefore, the Shareholder Agreement previously provided will be referred to herein as the "Member Agreement," utilizing the new nomenclature.

It is the intent that this corporation function as what has come to be known in the health care industry as a "physicians' organization" or "PO." The purpose of the organization is to bring physicians together as a group in order for them to compete more effectively in the contract managed care environment currently prevalent in the health care community. This means joining with other physicians and health care providers across hospital and geographic boundaries to provide access and a range of services; joining with insurance carriers and employers to

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

Matt Jenkins  
State of Utah Securities Division  
Department of Commerce  
March 31, 1994  
Page 2

develop strategies for reducing costs, improving efficacy of care, and establishing long-term, health care relationships; educating consumers; utilizing the health care system more appropriately; and selecting and supporting those hospitals that provide the best care in the most efficient manner.

Quality intends to obtain approximately 200 to 500 members, all of whom will be required to be residents of and medical doctors ("Physicians") licensed in the State of Utah. Each member will be subject to a rigorous qualification screening process to ensure that the Physician is highly skilled and provides medical services in a cost-efficient, sound manner. One of the principal ongoing activities of Quality will be to maintain a current database of health care information respecting the nature of professional services provided (e.g., average length of patient hospital stay; number, nature, and sequence of laboratory tests; adherence to established treatment protocols; and similar objective data available within the industry) by its members in order to monitor and maintain Physician quality. Only licensed Physicians who qualify under Quality's strict practice standards will be allowed to own the Memberships. Ownership of the Memberships will not be available to members of the general public. It is anticipated that only one share at \$2,500<sup>1</sup> per Share will be sold to each qualifying Physician/purchaser. The Memberships will be sold to entities, provided that one Membership must be purchased for each qualifying Physician/member within the entity. No commissions or fees will be charged or paid in connection with the sale of the Memberships. The Memberships will have the right to vote on corporate matters, with each Physician holding one Membership entitled to one vote.

At the time of purchasing a Membership, each Physician will be advised in writing that a Membership in Quality should not be viewed or acquired as an investment and should not be purchased with the expectation of deriving any dividends or similar profits from owning a Membership. Each Physician will be required to acknowledge in writing that the Membership interest evidences membership only and should not be considered a financial interest or investment. Physicians will be motivated to join Quality because of their understanding of the managed care market, the benefits of physicians' organizations, and their desire to survive in an increasingly competitive market by enhancing their bargaining position through collective action.

At the time of purchase, each member will be required to enter into a Member Agreement which limits transferability of the Memberships, specifies requirements for continuing credentialing, mandates active involvement in management, and other matters. The restrictions on transfer in the Member Agreement include an absolute prohibition of any sale of Memberships other than back to Quality, mandate a forced sale to Quality if the Physician/member ceases to practice medicine in Utah or on the occurrence of other events, and provide for the purchase of the interest of a spouse of a Physician/member in the event of termination of a marital relationship. The price at which the Memberships are to be sold is fixed by the Member Agreement at the price paid by the Physician, except when the Physician/shareholder ceases to practice medicine in Utah or on the occurrence of other specified events, in which case the price is fixed at \$100 per Membership. Certificates for Memberships are required to bear a legend noting the restrictions set forth in the Member Agreement. Alternatively, Quality may elect not to issue certificates for Memberships as contemplated by section 16-10a-627 of the Utah Revised Business Corporation Act, in which case Quality shall send members a written statement of the restrictions on transfer as provided in the notice requirement of the statute. For all of the terms of the Member Agreement, reference is made to a copy of the form of Member Agreement that has been provided to the Division. As noted above, it will be revised in accordance with the new terminology.

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<sup>1</sup> In the first 60 days after being introduced and invited to join Quality, Physicians will be allowed to purchase the Memberships at a cost of \$1,500 per share.

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

Matt Jenkins  
State of Utah Securities Division  
Department of Commerce  
March 31, 1994  
Page 3

At the time of purchasing a Membership, each Physician will also be required, as an express condition of becoming a member of Quality, to enter into a Participating Physician Agreement that is intended to embrace the full scope of professional health care services to be provided by the Physician within the physicians' organization concept. This agreement spells out the Physician's professional responsibilities to provide health care services within the Physician's specialty; to accept patients who are entitled to services under provider agreements negotiated by Quality with groups of insureds, employees, or others; to refer patients on a preferential basis to other Quality Physicians; to arrange to provide 24 hour, 7 day a week service to patients; to participate in mandatory recertification annually, and to meet other requirements. In addition, each Physician is required to accept payment for services rendered in accordance with the payment schedule negotiated by Quality with third parties, expressly appointing Quality as the Physician's attorney in fact to negotiate and accept such compensation schedule. The Participating Physician Agreement addresses a number of additional provisions covering the broad scope of health care services provided. Reference is made to a copy of the form of Participating Physician Agreement that has been provided to the Division for all of the terms of such agreement.

Physician/members will contract with Quality to provide their services, on a pre-determined fee basis, to entities and employers with which Quality contracts to provide services. These contracts will enable Quality, as representative of a cohesive physicians' group, to negotiate effectively with third party payors and large employers as well as hospitals and others to provide medical services on a cost-efficient, competitive basis. The relationship among the various participants in the health care equation--hospitals, surgery centers, insurers, self-insured groups, physicians' organizations, and other providers--may take many forms, including straightforward fee-for-service contracts, capitated service and payment plans, joint ventures, and other hybrid, cooperative arrangements. By rendering services, individual Physicians will generate income for their personal medical practices. Quality will generate revenues based on health care services provided by its Physician/members and its contractual relationship within the industry. Revenue will be used to deliver ongoing general and administrative expenses, for maintaining Physician credentialing, for monitoring health care services provided, and for negotiating agreements with hospitals, third party payors, employee groups, or others. The focus of Quality is to use excess revenue as incentives for Physicians excelling under criteria developed by the Physician/members of Quality for providing quality, cost-effective health care and would not be used to pay dividends to members. The incentive payments which reward efficient Physicians will be the primary financial incentive for the Physician/members. These incentives, with appropriate individual personal recognition, will be directly related the Physician's personal professional activities and will not be based on an ownership in Quality because each Physician/member will have the same single Membership. No dividends will be declared or paid to Physician/members.

The funds received from the sale of Memberships will be utilized solely to capitalize the operations of Quality, which will consist primarily of recruiting and contracting with Physicians, contracting with third party payors such as insurance companies and health plans, and maintaining the database necessary to support Quality's credentialing, Physician incentive, and other functions. The long-term goal of Quality is to become licensed as a Limited Health Plan, fully regulated by the Utah State Insurance Department. At that point, Quality will be able to offer "capitated" medical services directly to the public through negotiated contracts with large self-insured employers and others.

One of the primary objectives of the Member Agreement is to ensure that the voting control of Quality remains in the hands of active members of the medical community. Prospective Physician purchasers will be advised that the Memberships are not to be viewed as an investment, but as a membership in a network essential to enable them to compete in the managed care market.

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

Matt Jenkins  
State of Utah Securities Division  
Department of Commerce  
March 31, 1994  
Page 4

Quality will raise its initial capital from the Physician/members who will utilize the network. Physician/members will be required, as a condition of continuing participation, to be active in all phases of the operation of Quality. The Physician/members will actively participate and support the managed care network. Physician/members will serve on the quality assurance committee, the peer review and screening committee, the utilization review committee and other committees that will be needed for the operation of the managed care network. The success of the network will depend on Physician/members becoming active participants in the operation of the network.

For your convenience in reviewing this request, enclosed are copies of recent Securities and Exchange Commission letters and other materials cited in the discussion below.

**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 co-ordinate 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 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].

In *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the court set forth the following other characteristics 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 Memberships to be offered and sold by Quality are not the equivalent of "stock" for the purposes of applying Section 61-1-13(22)(b) of

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

Matt Jenkins  
State of Utah Securities Division  
Department of Commerce  
March 31, 1994  
Page 5

the Act or Section 2(1) of the 1933 Act because they bear little or no resemblance to stock as characterized by the *Tcherepnin* and *Landreth* courts.

First, the Membership interests are not freely transferable. Second, the members will not have any expectation of dividend rights or profit rights. By profits, the court has meant either capital appreciation resulting from the development of the initial investment or a participation in earnings resulting from the use of investors' funds. It is not anticipated that Membership interests will receive any dividends or distributions of income based on their stock ownership. Also, due to the fact that the Member Agreement prohibits the transfer of Memberships to a third party and requires that the Memberships be sold back to Quality at a price equal to the price the individual Physician originally paid for them (except in limited circumstances in which the price is fixed at \$100), there is no possibility for a Physician/member to profit from the ownership of Memberships. Finally, due to the fact that only one Membership will be sold to each Physician/purchaser, no member will have the ability to accumulate a larger ownership or voting interest than the other members.

Since the Memberships do not fall plainly within the usual concept or definition of "stock," consideration must be given to whether the 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 to be 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 mean that "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 *Howey* test to the characteristics of interests represented by the Memberships to be offered and sold by Quality, the memberships are not an "investment contract" or "other instrument commonly known as a security." The Quality Memberships are evidences of personal service participation, not an investment. While the persons who acquire the Memberships will do so in exchange for money, the Physicians to whom such the Memberships will be offered will be informed not to expect, and will not have any reasonable expectation of

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

Matt Jenkins  
State of Utah Securities Division  
Department of Commerce  
March 31, 1994  
Page 6

deriving, profits from the ownership of the Memberships. Income that is generated by the operation of Quality, will be used as financial incentives to Physicians based on their individual professional service as physicians. However, Quality will not pay to its Physician/members any dividends or make any distributions to them based on their Membership ownership.

The fact that Quality has the right under the Member Agreement to repurchase the Memberships at the price paid by the Physician to purchase the Memberships, except in certain circumstances when the price is fixed at \$100, coupled with the limitation on distributions on liquidation and dissolution, 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 Quality because of financial returns on the purchase of their Memberships. Rather they will purchase due to the prospect of being members of an integrated managed health care network that will negotiate with payors of health care services. The primary incentive is the ability of physician health care providers to control their own destiny in an environment that is increasingly being dominated by managed care arrangements that heretofore have typically been controlled by hospital, insurance companies, or others with established economic power bases. Accordingly, Physician/member will possess the requisite knowledge and expertise to evaluate the risks and merits of membership in Quality. Quality Physician/members will exercise control over Quality and will be required to participate actively as a condition of continued membership. Specifically, they will exercise control in the selection of payors with whom Quality contracts and the terms of those contracts. Additionally, Physician/members will control the qualification and admittance of its members.

Finally, any revenues or profits of the Physician/members will not be derived solely or even substantially from the efforts of others, 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 Quality will all be based economically on the personal professional services provided by Physician/members, 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. Physician/members of Quality 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. Quality Physician/members will use Quality as a means of increasing their own business. The "undeniably significant" effort in producing a Physician/shareholder's "profit" will be the effort of that individual member through the practice of medicine in substantially the same manner as before joining Quality. The Physician/members will obtain benefit by virtue of providing services through Quality, not by any economic interest in Quality in the form of a Membership. Where an enterprise merely allows a professional person to enhance his ability to earn income in the practice of his 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 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.*, CCH Current Vol. ¶ 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

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

Matt Jenkins  
State of Utah Securities Division  
Department of Commerce  
March 31, 1994  
Page 7

enterprise would not be found. The individual Physician/shareholder will realize little if any financial reward from his membership in Quality if he or she is not individually a successful medical practitioner. The organizers and managers of Quality could be successful in providing an environment in which success could be obtained and yet any one Physician/shareholder could fail due to his or her individual efforts. It is clear, therefore, that profits and losses of Quality and the individual Physician/shareholder are not interdependent.

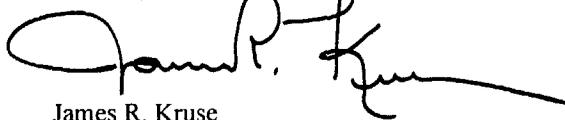
As a general public policy matter, it is noteworthy that the Commission as well as a number of states now have analyzed the legal and practical circumstances surrounding physicians' organizations and with a relatively uniform approach have determined that their organization and operation are unique and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

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On the basis of the above-stated facts and legal analysis, we request an interpretive response from the Division to the effect that the Memberships of Quality 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/llg

cc: George A. Hunt, Esq.  
Kay Allen, Ph.D