SALE AND LEASEBACK OF PAY PHONES RULED SELLING OF SECURITIES UNDER NEW YORK'S MARTIN ACT

A recent decision by a New York State court dramatically illustrates the potential significance of New York's Martin Act in the regulation of securities. The Martin Act, New York's version of a "blue sky" or state securities law, was designed to protect New York investors from exploitation by fraudulent or otherwise unsuitable schemes in the offer and sale of securities. Like the other state securities laws, however, it had been relegated to a distant "second" behind the federal regulatory scheme until the New York Attorney General saw it as an effective tool in his efforts to address, among other things, perceived abuses and irregularities in the securities markets.

In a recent decision, a New York court held that an investment program involving the sale and leaseback of pay telephones to investors constituted the sale of securities and thus should be regulated by the Martin Act. Perhaps one of the more interesting aspects of the case is that the court interpreted the phrase "investment contract" — one of the accepted definitions of a "security" — and reached a decision exactly opposite that of a U.S. Court of Appeals interpreting the same phrase under the same set of facts using the same precedents.

Background

The ruling stems from an action brought by New York Attorney General Eliot Spitzer alleging that Alan Justin Sr., his four sons, and related securities and insurance salespeople (the "Defendants") used an investment program involving the sale and leaseback of coin-operated pay telephones to defraud 667 New Yorkers, most of whom were senior citizens with limited financial means and a lack of investment experience.[1] The investors paid $7,000 for each of the pay phones, which were then leased back to ETS in exchange for a fixed fee. ETS agreed to maintain and operate the phones, make monthly payments to the investors in the amount of $82 per telephone, buy back the phones at any time after the first six months, and either renew the agreement or repurchase the phones for the original price after five years (the "ETS Program"). Spitzer alleged that New Yorkers lost roughly $18.5 million between 1998 and 2000, when ETS Payphones Inc. filed for bankruptcy, and that these losses were induced by the Defendants' material misrepresentations to investors, such as stating that the monthly lease payments were guaranteed, and inadequate disclosure of the risks involved with investing in the ETS Program.

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[1] *State of New York v. Todd J. Justin*, 2002-6226, 230 N.Y. Law J. 17 (Dec. 11, 2003).

The Defendants sought dismissal of the case based on a decision by the U.S. Court of Appeals for the 11th Circuit that ETS's telephone purchase and leaseback arrangement was not an "investment contract" or "security" under federal securities laws.[2] The Defendants cited the 11th Circuit's holding as support for the proposition that, regardless of whether ETS became involved as a lessee and/or service provider, a customer's purchase of a pay phone should not be characterized as a security under the Martin Act because it is not an "investment contract" as defined under federal law and interpreted by the New York courts.[3]

The New York Court's Decision

The issue came before the New York court on the Defendants' motion for summary judgment made in reliance upon the analysis of the 11th Circuit. The New York court held that the ETS Program constituted an investment contract and, thus, a security under the Martin Act. To reach this conclusion, the New York court had to determine whether the sale-leaseback arrangement was an "investment contract."

In defining the term "investment contract", New York courts follow *Securities and Exchange Commission v. Howey*, 328 U.S. 293 (1943), the seminal case that established a test for the existence of such a contract. Under *Howey*, a transaction is an investment contract if it involves (1) an investment (2) in a common enterprise (3) with a reasonable expectation of profits to be derived solely from the efforts of others.[4] In *Securities and Exchange Commission v. ETS*, the 11th Circuit applied the *Howey* test to the ETS Program and held that while investors had made an "investment" under the first criterion, it was unnecessary to determine whether the investment was in a common enterprise because the final criterion, "expectation of profits solely from the efforts of others," was clearly unsatisfied under federal law.

The New York court analyzing the same facts using *Howey* held that payphone investors indeed made an "investment" and rejected the Defendants' argument that the lease of the telephone and the initial purchase of the telephone were separate transactions. The ETS Program was marketed and sold to investors as a single transaction. The court noted that "although investors allegedly 'owned' a telephone, a 'location' for that phone and use of telephone wires, the 'ownership'

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2 The Securities and Exchange Commission is currently maintaining a suit against ETS for defrauding approximately 10,000 investors nationwide out of more than $300 million. The SEC successfully obtained an injunction in the District Court, but the decision was reversed by the 11th Circuit Court of Appeals on the ground that the federal securities laws did not apply. The U.S. Supreme Court has agreed to hear the case this spring. *Securities and Exchange Commission v. ETS Payphones Inc.*, 300 F.3d 1281 (11th Cir. 2002), *cert. granted*, 71 U.S.L.W. 3553 (U.S. Apr. 21, 2003) (No. 02-1196).

3 *See Matter of Gardner*, 97 Misc. 2d 806, 812 (N.Y. Sup. Ct. 1978).

4 *See Howey*, 328 U.S. at 298.

piece was, as in *Howey* (which dealt with portions of a citrus grove), merely 'a convenient method of determining the investors' allocable shares of the profits,' while the transfer of 'ownership' of the phones, in this case, or the shares of the orange grove in *Howey*, was 'purely incidental.'"[5]

In addressing the requirement that there be a "reasonable expectation of profits derived solely from the efforts of others," the 11th Circuit stated that the concept of profits "has a limited meaning under federal securities law"[6] and that profits 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. . . ."[7] The 11th Circuit held that the fixed lease payments made to investors were neither capital appreciation nor participation in earnings by the investor. The 11th Circuit further noted that investors were contractually entitled to receive the monthly lease payments, so they would receive returns irrespective of the efforts of ETS.

The New York court rejected the 11th Circuit's analysis, noting that holders of stocks and bonds often are entitled by terms of the security to interest or dividends at specified rates and at specified times without affecting the conclusion that such instruments are securities. Thus, the New York court concluded that although investors were "guaranteed" a specific return each month, that "guarantee" does not remove the program from the definition of a security — at least for state law purposes — and, thus, from the scrutiny of state regulators. In fact, the court stated that it was the very guarantee of interest that led to the resulting bankruptcy of ETS and losses to investors. The court also noted that courts have found this criterion satisfied where, as is the case here, there is an expectation that the promoter will repurchase the object of the investment at a later date.

The New York court also addressed the second criterion under *Howey*, whether the investors were involved in a common enterprise. As noted above, the 11th Circuit had concluded it was unnecessary to address this criterion since it found the ETS program did not meet the "expectation of profits" test. The New York court, in contrast, concluded that there was a direct relationship between the efforts of ETS and the success of the investors. The guaranteed monthly payments were dependent entirely upon the efforts of ETS in servicing and maintaining the phones, and the investors were entirely passive. Thus, having found that each *Howey* criterion was satisfied, the New York court concluded that the ETS Program is an investment contract and a security for purposes of the Martin Act. It remains to be seen whether the U.S.

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[5] *State of New York v. Todd J. Justin*, 2002-6226, 230 N.Y. Law J. 17 (Dec. 11, 2003), quoting *Howey* at 300.

[6] *See ETS*, 300 F.3d at 1284.

[7] *See United Housing Found. v. Forman*, 421 U.S. 837, 852-853, *reh. denied*, 423 U.S. 884 (1975).

Supreme Court will affirm the 11th Circuit's decision, but even if it does, the decision in *Justin* will continue to apply as a state law matter unless reversed by a higher court.

The decisions of the 11th Circuit and the New York court do not have any direct impact on each other, but they interpreted the definition of "security" under different statutes and the stark difference in interpretation of the phrase "investment contract" using the same United States Supreme Court case gives rise to difficult issues. The United States Supreme Court will hear an appeal of the 11th Circuit case, so it is likely a clearer interpretation of the *Howey* doctrine will result. Nevertheless, that may not resolve the matter in New York, resulting in inconsistent definitions and inconsistent interpretations that may cause conflict between the federal and state securities law schemes.

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If you have any questions about the *Justin* decision, or to obtain a copy of the decision, please contact the partner with whom you regularly work.

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