June 24, 2019

New York's Highest Court Holds that Medical Practices that Cede Too Much Control to MSOs Are "Fraudulently Incorporated" and Ineligible to Be Reimbursed by No-Fault Automobile Insurers

On June 11, 2019, the New York Court of Appeals (the "Court")—the highest court in New York State—issued a rare opinion on the State's broad corporate practice of medicine prohibition. In a case that is likely instructional with regard to the defining the scope of unlicensed individuals or management services organizations' ("MSOs") ability to exercise "control" over professional practice entities in New York, in *Andrew Carothers, M.D., P.C. v. Progressive Insurance Company* (the "*Carothers* case"), the Court held that medical practices that cede too much operational and financial control to MSOs, are "fraudulently incorporated" and thus ineligible to be reimbursed by no-fault automobile insurers.

Factual Background

The facts of the *Carothers* case[1] involve a New York professional service corporation ("PC") that performed MRI services on patients who were involved in automobile accidents. Under New York's "no-fault" insurance law, people injured in car accidents are permitted to apply for insurance compensation regardless of their individual fault, and the law further allows those persons to assign their insurance compensation to medical providers.[2] A radiologist, Andrew Carothers, formed the provider at issue, Andrew Carothers, M.D., P.C. in 2004 and, later, Dr. Carothers agreed to lease premises and equipment from a non-physician, Hillel Sher. Sher's companies acted as an MSO for Carothers' PC.

Dr. Carothers, who was in financial distress, agreed to terms that the Court viewed as "solely" benefitting Sher and the MSO. As an example, the Court noted the following aspects of the MSO arrangement as suspect:

- *Equipment Leases*. The equipment leases were far above fair market value—Carothers' PC paid $547,000 per month for MRI equipment.[3]

- *Termination Rights*. Sher had the right to terminate each lease without cause with 30 days notice while Carothers had no ability to terminate without cause.

- *Involvement in Patient Care by Unlicensed Owner*. As the "owner" of the PC, Dr. Carothers had virtually no involvement in patient care, as he hired a second radiologist and, during the period in question, Carothers reviewed at most 79 out of 38,000 reports. Carothers did not evaluate or discipline his employees, and at trial an expert witness testified that the quality of the MRI results were "abysmal."[4]

- *Involvement in Operations by Unlicensed Owner*. Dr. Carothers was not involved with business administration; instead, Irina Vayman, a non-physician, ran the business, including contacting referring physicians. Testimony at trial showed that Vayman was consistently transferring funds, received from insurance companies paying out no-fault insurance claims, from the PC to her and Sher's personal accounts.

[1] —N.E.3d—, 2019 N.Y. Slip Op. 04643 (June 11, 2019), http://www.nycourts.gov/ctapps/Decisions/2019/Jun19/39opn19-Decision.pdf. Pin citations to the case refer to the slip opinion provided at the foregoing website.
[2] *See* N.Y. Ins. Law § 5221.
[3] Slip op. at 3.
[4] *Id.* at 4.

Procedural History

Based on these facts, several no-fault automobile insurance carriers stopped paying the PC's no-fault claims in 2006, at which time the practice closed when Dr. Carothers could not obtain additional loan advances to sustain his PC. Litigation soon followed when the PC sued the insurance carriers for non-payment of the insurance claims. At trial, the jury was required to determine whether Dr. Carothers really owned and controlled the PC.

As a defense to non-payment, the insurance carriers argued that the PC was not actually practicing medicine through its physicians and thus was not entitled to payment because it was fraudulently incorporated. To buttress their defense, the insurance carriers cited a prior New York Court of Appeals case allowing insurers to withhold payments when a professional corporation's "ostensible or real managers engaged in conduct 'tantamount to fraud.'"[5] In response, the PC argued that this standard requires an insurer to establish "the traditional elements of fraud," including fraudulent intent, to withhold payment. The trial court rejected the PC's argument and instructed the jury that it could find that the practice was fraudulently incorporated, and insurers could withhold payment for claims, if "reasonable people would say" that Sher and Vayman were de facto owners of or "*exercised substantial control* over the corporation."[6] The jury found that Sher and Vayman controlled the PC, and that it was fraudulently incorporated such that the insurance companies could rightfully deny payment of claims.

The Appellate Division upheld the jury charge in 2017 and the PC then appealed to the Court of Appeals.

Court's Analysis

New York possesses one of the strongest prohibitions on the corporate practice of medicine, which mandates that only licensed professionals may own or control a professional service corporation.[7] The Court addressed a specific aspect of the corporate practice of medicine doctrine pertaining to "no-fault" insurance laws. In *State Farm Mutual Automobile Insurance Co. v. Mallela*,[8] the Court held that insurance carriers could withhold payment for medical services provided by a professional service corporation that had been "fraudulently incorporated." Fraudulent incorporation included professional service corporations that are, in practice, actually owned or controlled by an unlicensed professional. Insurers are not required to reimburse health care providers if the "provider fails to meet any applicable New York State or local licensing requirement necessary to perform such service in New York."[9]

In *Mallela*, the Court interpreted that provision to allow insurance carriers to withhold reimbursement for no-fault claims that were "provided by fraudulently incorporated enterprises to which patients have assigned their claims."[10] Thus, a medical provider that was not solely owned and controlled by a physician could not charge insurance carriers for no-fault insurance reimbursements.[11]

In the *Carothers* case, the Court addressed a related question: whether a jury had to find "fraudulent intent or, at least, conduct 'tantamount to fraud.'"[12] The PC argued that the Court's language in *Mallela* required a jury to find common-law fraud on the theory that Sher's and Vayman's conduct in running the PC did not amount to common-law fraud. The Court rejected this theory, stating that neither New York regulations nor *Mallela* required a showing of common-law fraud. The Court reasoned that a party "in material breach of the foundational rule for professional corporation

[5] *Id*. at 9 (quoting *State Farm Mut. Auto. Ins. Co. v. Mallela*, 4 N.Y.3d 313, 322 (2005)).
[6] *Id.* at 10.
[7] Slip op. at 14 (citing N.Y. Bus. Corp. Law § 1507); *see also* N.Y. Educ. Law § 6529.
[8] 4 N.Y.3d at 320.
[9] 11 NYCRR § 65-3.16(a)(12).
[10] *Mallela*, 4 N.Y.3d at 319.
[11] *See* Slip op. at 16.
[12] *Id.* at 17.

licensure—namely that it be controlled by licensed professionals—[is] enough to render [that party] ineligible for reimbursement."[13] Accordingly, the PC, which the jury initially found to be controlled by Sher and Vayman on the facts, was in material breach of such a "foundational rule" and thus ineligible for reimbursement.

Implications

This decision is notable because it serves as a recent and notable reminder of the requirement in New York to abide by legal entity formalities when establishing and operating professional service corporations and other similar medical provider entities. It is an increasingly common practice for there to be a close relationship between a professional practice entity and an MSO that provides most, if not all, of the administrative and management services required by the practice entity, including many of the same services offered by Sher—leasing real estate, equipment, and various other administrative aspects of the business.

Along with the assurance of discontinuance issued by the New York State Attorney General in the *Aspen Dental* case,[14] the *Carothers* case reaffirms the need to establish guardrails that prevent unlicensed MSOs or individuals from controlling or owning *too much* of the professional service corporation's operations, especially when those functions may impede on professional decision-making. While the scope of this case was limited to "no-fault" automobile reimbursement, which is especially ripe for litigation based on the precedent from the *Mallela* decision, the Court's broader analysis may be instructive for professional entities and MSOs that operate beyond the no-fault automobile insurance market.

If you have any questions about this case or structuring a PC-MSO relationship, please feel free to contact your usual Ropes & Gray advisor.

[13] *Id.* at 18.

[14] In re Aspen Dental Management, Inc., Assurance No: 15-103 (June 18, 2015), https://ag.ny.gov/pdfs/ADMI_AOD.pdf; Deborah L. Gersh et al., *Dental Service Organizations Face Unintended Consequences*, N.Y. LJ (Aug. 10, 2015), https://www.law.com/newyorklawjournal/almID/1202734009858/Dental-Service-Organizations-Face-Unintended-Consequences/.