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Expert Analysis

A Warning to Physician Practice ‘Managers’

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One of the more interesting developments in health care in recent years has been the proliferation of management service organizations (MSOs). These businesses offer private medical practices the opportunity to outsource most or even all of their back-office operations, e.g., reception, medical records, medical equipment, billing and collection, janitorial services, non-professional employees, and so on. Some MSOs go further and offer turn-key office space, loans to capitalize a growing practice, and other items and services. The appeal of this outsourcing option is that it can reduce the practice’s overhead while also freeing the physicians to spend more time providing medical services to their patients, thereby increasing their productivity and revenues. Because of their profit margins, MSOs have attracted considerable private equity interest and investments.

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As we explained in a previous column, “Fee Splitting Prohibition and Physician Practice Management Arrangements,” NYLJ, July 23, 2013, New York has strict limits on what an MSO can do and how it can be paid. The Business Corporation Law, which authorizes the incorporation of professional corporations, strictly limits ownership and control of such entities to New York-licensed professionals. See, e.g., NY Bus. Corp. Law §§1503(b), 1504(a), 1507(a), 1508(a). New York’s prohibition on the corporate practice of medicine forbids an MSO from interfering with the physicians’ ownership and control of the medical practice or in the exercise of their independent medical judgment in rendering services to patients. New York also has a statutory prohibition on fee-splitting that bars charging and paying for MSO services on the basis of a percentage of the medical practice’s gross or net income. N.Y. Education Law §6530-31. See also 8 NYCRR §29.1(b).

An important Appellate Division decision issued last month highlights the consequences of ignoring these requirements and prohibitions. While the case involved automobile no-fault insurance medical claims and presented particularly extreme facts, it has significance for all MSOs operating in New York and the medical practices that they service.

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Medical Practice

In Andrew Carothers, M.D., P.C. v. Progressive Insurance, 26 Misc. 3d 448 (N.Y.C. Civil Ct. Richmond Co. 2009), a no-fault automobile insurer denied thousands of claims for MRI scans for patients allegedly injured

in automobile accidents because the insurer claimed that the medical practice, formed by Dr. Andrew Carothers, a radiologist, was fraudulently incorporated in that it was actually owned and controlled by the landlord of the practice's premises, Hillel Sher, and the practice's executive secretary, Irina Vayman, neither of whom is a physician. At trial, the insurer's expert witnesses testified that the practice's profits were funneled to Sher and Vayman through "grossly inflated equipment lease payments" made to a company owned and controlled by Sher.

For example, Sher's company charged the practice $547,000 per month for the practice's use of old MRI equipment that an expert testified could have been purchased for a one-time payment of $600,000. A forensic accountant testified that one of Sher's companies leased equipment for $9,800 per month and then charged the practice $75,000 per month for the same machine. Vayman in turn hired all of the practice's personnel and signed all of the practice's checks. The accountant testified that the practice's money went to Sher's companies each month, leaving no money in the practice's accounts, and that a total of $8.7 million went from the practice's account to one of Sher's companies, and Vayman received $882,600 of those funds. In the two-year period that the practice operated, Sher and Vayman received a total of $12.2 million while Carothers was paid $133,000.

Sher and Vayman were deposed prior to the trial but invoked their Fifth Amendment privilege against self-incrimination in response to almost all of the questions that were put to them. At trial, Carothers' testimony revealed that he knew little about the practice's operations and finances; did not recognize the names of some of the practice's employees, some of whom were Sher's relatives; and was unable to account for the practice's transactions with Sher. A neuro-radiologist expert testified as to the poor quality of the MRI scans, many of which could not be read, and that this was indicative of Carothers' lack of quality control, direction and supervision of the practice.

> As long as the MSO does not effectively own or control the medical practice or its physician owners, does not interfere in their medical decisions, and does not get paid on the basis of a percentage of the practice's gross or net revenues, both the practice and the MSO should be on safe ground.

The Civil Court enumerated 13 different factors that the jury might consider in determining whether the practice was fraudulently incorporated. Those factors were:

(1) whether the agreements between the practice and the entities owned by Sher, which leased the facilities and the equipment to the practice, were the product of arm's-length transactions or whether the terms of those agreements were designed to give Sher and those entities substantial control over the practice and to channel its profits to Sher;

(2) whether and to what extent Sher and Vayman had exercised dominion and control over the practice's assets, including its bank accounts;

(3) whether and to what extent Dr. Carothers, Sher and Vayman had made capital investments in the practice;

(4) whether and to what extent Sher and Vayman had used practice funds for personal rather than for corporate purposes;

(5) whether and to what extent Sher and Vayman had the ability to bind the practice to legal obligations with third parties;

(6) whether and to what extent Sher and Vayman had been responsible for hiring, firing and/or payment of the salaries of the practice's employees, and the extent to which they had dictated policy decisions;

(7) whether and to what extent the day-to-day formalities that are part and parcel of corporate existence (including the issuance of stock, election of directors, holding of corporate meetings, keeping of books and records and

filing of corporate tax returns) had been followed;
(8) whether and to what extent the practice and Sher's companies shared common office space, addresses, employees and telephone numbers;
(9) whether and to what extent Carothers had played a substantial role in the day-to-day operation of the practice;
(10) whether and to what extent Sher and/or Vayman had assumed the financial obligations of the practice as if they were their own;
(11) whether and to what extent practice funds had been commingled with those of the other entities owned by Sher;
(12) whether and to what extent Carothers, Sher and Vayman had shared the risks, expenses and interest in the profits and losses of the practice; and
(13) whether and to what extent Sher and Vayman had been involved in making professional medical decisions regarding the practice.

The trial court jury returned a verdict finding, among other things, that the insurer had proven by clear and convincing evidence that the practice was fraudulently incorporated. On appeal, the Appellate Term upheld this finding and the list of factors set forth by the trial court to the jury for determining whether Sher and Vayman were de facto owners or exercised substantial control over the practice. 42 Misc. 3d 30 (Sup. Ct. App. Term, 2d Dept. 2013).

The Appellate Division granted leave to appeal, and affirmed the Appellate Term's decision. __ A.D.3d __; 2017 NY Slip Op. 02614, (App. Div. 2d Dept. April 5, 2017). As had the courts below, the Appellate Division relied upon the landmark 2005 decision in *State Farm v. Mallela*,[7] in which New York's Court of Appeals held that a medical provider that is not solely owned and controlled by licensed physicians as required by Business Corporation Law §1507(a) and 1508(a) is ineligible for no-fault medical payments; that no-fault insurers may look at the actual ownership and operation of the practice to determine whether the practice is actually controlled or owned by an unlicensed individual in violation of state and local law; and that no-fault insurers may withhold payments for medical services provided by a professional corporation that has been "fraudulently incorporated" to allow non-physicians to share in ownership and control. 4 N.Y.3d 313 (2005) (The writer authored an amicus brief in support of State Farm's position in the *Mallela* appeal.) The Appellate Division also cited the requirements of the Business Corporation Law for professional corporations *after* they are incorporated:

- professional service corporations must be owned and controlled only by licensed professionals;
- only licensed professionals may render the services provided by professional corporations;
- shareholders may not transfer their voting power to any person who is not a licensed professional in the field;
- only shareholders or the licensed professionals engaged in the practice may be officers and directors of professional corporations; and
- any agreement by a shareholder transferring the voting power of his/her share to individuals who are not authorized by law to practice the profession is void.

The court also referenced the regulations of the Department of Financial Services which state that a provider of health care services is not eligible for no-fault reimbursement

> if the provider fails to meet any applicable New York State or local licensing requirement necessary to perform such service in New York … .

11 NYCRR 65-3.16[a][12].

The practice's lawyers challenged the 13 factors that were part of the Civil Court's jury charge, but the Appellate Division found that the jury charge as a whole adequately conveyed the principles articulated by the Court of Appeals in its *Mallela* decision:

> The charge properly focused the jury on the question of whether Carothers was a mere nominal

owner of the plaintiff, and if, in actuality, nonphysicians Sher and Vayman owned or controlled the plaintiff such that the profits were funneled to them. The Civil Court properly instructed the jury to consider whether Sher and/or Vayman shared in the profits of the plaintiff, and that the jury could consider whether the leases entered into between the plaintiff and Sher's companies were arm's length or meant to funnel profits to Sher.

The court went on to note that the jury charge properly required the insurer to establish by clear and convincing evidence that Sher and/or Vayman were "de facto owners" of the practice or exercised "substantial control" over it; and that to find de facto ownership, that either Sher and/or Vayman exercised "dominion and control over" the practice and its assets, and "shared the risks, expenses, and interest in the profits and losses" of the practice. The jury was also properly instructed that they must find that Sher and/or Vayman had a "significant role in the guidance, management and direction of the business."

Analysis

It is important to emphasize that this case involves particularly egregious facts, and it occurred in the context of no-fault automobile insurance medical benefits, where fraud and abuse continue to be a major problem. This decision also is based solely on New York law, and is not necessarily indicative of restrictions on the control of medical practices or the legitimacy of MSO arrangements in other jurisdictions.

Nonetheless, there is much guidance for New York MSOs and physician practices in these decisions. MSO agreements with practices must respect the autonomy of the physicians and their practices. The factors used by the Civil Court and subsequently endorsed by the appellate courts in weighing whether there is impermissible ownership or control of a medical practice will likely set the standard for future cases—no-fault or otherwise—where litigants challenge the legitimacy of a medical practice or the legality of an MSO arrangement with a medical practice. Some of these factors by themselves are not dispositive of the issue of whether a practice is fraudulently incorporated or whether an MSO agreement should be voided.

However, so-called "captive physician practices" like Dr. Carothers,' where a layperson or general business corporation pervasively controls the medical practice and exploits it for their own personal gain may not withstand judicial scrutiny when these factors are weighed against the totality of the circumstances.

MSO's typically commit to significant investments in managing the business side of physician practices in return for a long-term agreement to provide management services to the practice, and as such their management service arrangements must be carefully structured and drafted. As long as the MSO does not effectively own or control the medical practice or its physician owners, does not interfere in their medical decisions, has fair market value and arm's length transactions with the practice, and does not get paid on the basis of a percentage of the practice's gross or net revenues, both the practice and the MSO should be on safe ground. When in doubt, the factors set forth by the courts in *Carothers* can provide a helpful checklist to determine whether the arrangement is proper or could run afoul of the law.

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