

The Practical Import of the Carothers Decision on New York Practice Management Arrangements

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Summary

On April 5, 2017, the Appellate Division of the New York Supreme Court issued a decision in *Andrew Carothers, M.D., P.C. v. Progressive Insurance Co.*, affirming a verdict by the lower court which allowed a defendant insurance company to withhold no-fault insurance payments from a professional service corporation that was unlawfully controlled by unlicensed persons. While the application of the Carothers decision beyond the no-fault insurance space is unclear, the facts of the case can be instructive for unlicensed management services organizations providing practice management services to New York professional entities.

In Depth

On April 5, 2017, the Appellate Division of the New York Supreme Court (Court) issued a decision in *Andrew Carothers, M.D., P.C. v. Progressive Insurance Co.*, No. 2013-10969, 2017 WL 1240262 (N.Y. App. Div. Apr. 5, 2017), affirming a verdict by the lower court which allowed a defendant insurance company to withhold no-fault insurance payments from a professional service corporation that was unlawfully controlled by unlicensed persons. Of particular note, the Court upheld the lower court's jury instructions including a list of 13 factors to consider in determining whether the unlicensed persons were *de facto* owners of, or exercised undue control over, the professional corporation. Though the import of this case beyond the no-fault insurance space is unclear, the decision (and the jury instructions in particular) serves as helpful guidance in shaping the contours of New York professional practice management arrangements.

Background of the Case

Beginning in 2004, Dr. Andrew Carothers, a radiologist, owned a New York professional service corporation (PC) providing professional services at three MRI facilities in New York City. The PC operated pursuant to an arrangement with two unlicensed individuals. Among other things, the PC leased the MRI facilities and all of the equipment used at the facilities from the unlicensed individuals, with rent amounts significantly above market value. Further, the unlicensed individuals were given

authority over the hiring and firing of all PC personnel, and maintained control (including signatory authority) over the PC's operating bank accounts. Each month, all of the PC's revenue was paid or transferred, in some form, to the unlicensed individuals. Though he owned the shares of the PC, Dr. Carothers had very little involvement in the day-to-day management and operations of the business. Overall, during the two years in which Dr. Carothers owned the PC, he earned a total of \$133,000; over that same time period, approximately \$12.2 million was paid or transferred to the unlicensed individuals.

From 2005 to 2006, the PC performed approximately 38,000 MRI scans at the facilities, most of which were performed for patients allegedly injured in motor vehicle accidents eligible to receive no-fault insurance benefits. These patients assigned their right to receive the no-fault insurance benefits to the PC, and the PC billed applicable insurance companies to recover payment on the assigned claims. When various no-fault insurers failed to make payments on these claims, the PC commenced several actions, including the action described herein against the defendant, Progressive Insurance Company (Progressive).

As a defense to its non-payment of the PC's claims, Progressive contended that the PC was not entitled to reimbursement because the PC was "fraudulently incorporated." As articulated in *State Farm Mutual Automobile Insurance Co. v. Robert Mallela*, 4 N.Y.3d 313, 827 N.E.2d 758 (2005), a New York professional corporation will be considered to have been "fraudulently incorporated" where unlicensed persons exercise rights of *de facto* ownership and/or control over the professional corporation.

Following the trial, the lower court instructed the jury that it should consider the totality of the circumstances in determining whether the unlicensed individuals were *de facto* owners of the PC and/or whether the unlicensed individuals exercised substantial dominion and control over the operations of the PC. The lower court's jury instructions included a non-exhaustive list of 13 factors to consider, including:

- Whether the unlicensed persons' dealings with the PC were arm's-length or were designed to give the unlicensed persons substantial control over the PC and channel profits to them;
- Whether the unlicensed persons exercised dominion and control over the PC assets, including bank accounts;
- Whether and to what extent the PC funds were used by the unlicensed persons for personal rather than corporate purposes;
- Whether the unlicensed persons were responsible for the hiring, firing and payment of salaries of the PC employees;
- Whether the day-to-day formalities of corporate existence were followed, including the issuance of stock, election of directors, holding of corporate meetings, keeping books and records, and filing tax returns;
- Whether the PC shared common office space and employees with companies owned by the unlicensed persons; and
- Whether the professional shareholder of the PC (Dr. Carothers) played a substantial role in the day-to-day and overall operation and management of the plaintiff.

On appeal, the Court upheld the lower court's instructions but notably indicated that none of the factors enumerated in the instructions, standing alone, could support a finding of fraudulent incorporation.

Practical Import

While the application of the *Carothers* decision beyond the no-fault insurance space is unclear, the facts of the case (as well as the Court's affirmation of the lower court's jury instructions) can be instructive for unlicensed management services organizations (MSOs) providing practice management services to New York professional entities.

In light of the factors listed in the *Carothers* jury instructions, as well as other applicable sub-regulatory guidance such as the New York Attorney General's settlement with Aspen Dental Management, MSOs should ensure that practice management arrangements with New York professional entities are arm's-length and do not create any undue rights of dominion or control by an unlicensed person. Among other things, MSOs should ensure that any fees charged to a New York professional entity in exchange for management and/or administrative services are fixed, fair market value and are consistent with an arm's-length transaction. As a further example, MSOs should also ensure that any equipment or facility leases to a New York professional entity are in writing and are consistent with fair market value. Any loans from an MSO to a professional practice should be *bona fide* loans as evidenced by a written agreement and subject to fair market repayment terms. It should also be made clear that the owner of the professional entity should maintain control over the operations of the practice, including without limitation control over practice bank accounts and authority to make personnel decisions.

Of note, (as the Court indicates) no single factor listed in the *Carothers* jury instructions standing alone can substantiate a finding that a New York professional entity impermissibly delegated control or authority to an unlicensed person; however, if a practice management arrangement involves several of the circumstances listed therein, such arrangement may be subject to legal challenge. Accordingly, MSOs and New York professional practices should take care in developing practice management arrangements, using the *Carothers* decision as helpful input, to ensure that the appropriate level of control over practice operations remains with the practice.

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National Law Review, Volume VII, Number 109

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