

Maintaining The Integrity Of Physician-Owned Practices

By **John Fanburg**

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The market for the buying and/or selling of medical practices has never been more active than it is today. The uncertainty in providing health care services in private practice environment is fueling this frenzy to sell to Wall Street or to hospitals. In addition, declining or flat reimbursement, coupled with the need for additional capital to remain competitive, are also prompting the growing number of transactions.

Two recent cases, one in New York and one in New Jersey, will impact how these transactions should be structured, which will ultimately impact the financial visibility of the transactions that have already been consummated in recent years, as well as future transactions.



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In *Allstate Insurance Company v. Northfield Medical Center, P.A.*, a unanimous New Jersey Supreme Court decision ruled that a New York healthcare attorney and California chiropractor violated New Jersey's Insurance Fraud Prevention Act when developing a "MD/DC," (multi-specialty medical practice). Although the case centered on the relationship between a chiropractor and a medical doctor within the medical practice, the court held that, in essence, the medical practice was a sham and that the chiropractor controlled every aspect of the medical practice, thus violating New Jersey's corporate practice in medicine and prohibitions.

In *Andrew Carothers, M.D.P.C. v. Progressive Insurance Company*, the Supreme Court of New York, Appellate Division, Second Department, found that because the medical practice gave up so much control to a management company owned by nonphysicians, and because all nonclinical aspects of the medical practice were furnished to the same management company, in reality the medical practice was controlled by nonphysicians, thus violating New York's prohibition on the corporate practice of medicine.

Allstate Facts

In *Allstate*, the New York attorney and California chiropractor were found to have engaged in fraud because of their participation in the establishment of a medical practice whereby a practitioner with a limited scope of practice could excerpt control over how the medical practice could be run. The practice model promoted by the attorney allowed a chiropractor to retain control of the finances of a medical

practice through a series of contracts. The goal of the contracts was to allow the chiropractor to extract profits from, and maintain control over, the medical practice. Although a majority of the stock was held by the medical doctor, all profits were paid over to the management company, solely owned by the chiropractor.

Further, to retain control over the medical practice, the doctor was required to execute an undated resignation letter. The doctor was also required to sign an undated "Affidavit of Non-Issue or Lost Certificate." With these two documents, the chiropractor could remove the medical doctor at any time and replace him or her with a new doctor deemed more favorable to the chiropractor. An additional document was prepared which provided that the medical doctor would be required to pay a \$100,000.00 "break-up fee" if the medical doctor terminated any of the interlocking agreements with the chiropractor or management company. A combination of the issues above had the effect of preventing the medical director from seizing control of the practice from the real owner, the chiropractor.

Carothers Facts

In Carothers, Andrew Carothers, M.D., a radiologist, leased three MRI facilities from companies owned and controlled by nonphysicians. At trial, the evidence presented showed that Carothers had no real involvement in the management of the medical practice, and that the nonphysician owners of the management company had hired all the personnel, signed all of the checks of the medical practice operating account, and, over a two-year period, the management company had received \$12.2 million in fees, while Carothers earned \$133,000.00.

As a result of these cases, recent transactions with private equity firms and hospitals or legal affiliation must be reviewed and if necessary, be restructured to conform with the decisions in these cases.

Typically, in the private equity and hospital affiliate acquisition scenarios, the nonclinical assets of the practices are typically sold to the private equity fund, hospital or related entities not owned by nonphysicians. The assets are then leased back to the medical practice through a series of agreements or through a management services agreement.

In exchange for the provision of the office, equipment, fixtures and furniture, nonclient personnel and management services, the medical practice pays to the management company all, if not almost all, of its revenues after the payment of physician compensation and physician malpractice premiums. Thus, all profits of the practice are paid over to the management company. The courts found in both cases that due to the significant amount of money moving from the practice to the nonphysicians, and due to the significant exercise of control over the practice's business and assets that essentially, the nonphysicians were in control of the medical practice.

Examples of significant control over the practice that lead to these rulings include:

- Payment for equipment far in excess of fair market value;
- Hiring of all personnel;
- The physician's lack of knowledge about the practice's finances;
- The exercise of significant and dominion control over the practice's assets, and
- The difficulty for the physician to terminate the management agreement without disrupting the practice's ability to practice medicine

Recent transactions must now be reviewed to ensure that the integrity of the private practice of medicine resides in the physician-owned practice. If the purpose of the contractual arrangements and transactions was to extract profits out of the practice, further maintaining control of the medical practice, New Jersey and New York courts may find “fraud” in the transaction.

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