FRAUDULENTLY INCORPORATED ENTITIES

"Basic Economic Loss" Reimbursement Does Not Require Payment to Fraudulently Incorporated Entities

Insurance Law § 5102 *et seq.* requires no-fault carriers to reimburse patients or assignees for "basic economic loss." In 2002, the Superintendent of Insurance passed a regulation pursuant to the Insurance Law which provides that "basic economic loss" reimbursement is not required for unlicensed or fraudulently licensed health care providers. Specifically, 11 NYCRR 65-3.16(a)(12) provides :

> A provider of health care services is not eligible for reimbursement under section 5102(a)(1) of the Insurance Law if the provider fails to meet any applicable New York State or local licensing requirement necessary to perform such service in New York or meet any applicable licensing requirement necessary to perform such service in any other state in which such service is performed. 11 NYCRR 65-3.16(a)(12).

***State Farm Mutual Auto Insurance Company v. Mallela* (2005)**

In State Farm Mutual Auto. Ins. Co. v. Mallela, 4 N.Y.3d 313, 794 N.Y.S.2d 700 (2005), the New York Court of Appeals held that insurance carriers may withhold no-fault reimbursement payments for medical services provided by fraudulently incorporated enterprises to which insureds have assigned their claims pursuant to 11 NYCRR 65-3.16(a)(12).

In that case, State Farm, the no-fault carrier, filed a complaint seeking a declaration that it need not reimburse the defendants (health care providers holding assigned no-fault claims) because defendants were fraudulently incorporated medical corporations. Specifically, State Farm alleged that the defendants were fraudulently incorporated because they paid licensed physicians to pose as nominal owners in order to gain status as a medical professional corporation. Pursuant to Business Corporation Law § 1507, all shareholders of a professional service corporation must be authorized to practice the profession which the corporation is authorized to practice. Accordingly, State Farm argued, defendants were fraudulently incorporated.

State Farm never alleged that the medical care rendered by the defendants was unnecessary or improper. The defendant-assignees argued that their no-fault reimbursement claims should not be denied because (presumably) the patients received appropriate care from a qualified health care professional. Accordingly, defendants argued that they were entitled to reimbursement, even if they were fraudulently incorporated. The defendant-assignees also argued that 11 NYCRR 65-3.16(a)(12) conflicts with the prompt payment goal New York's no-fault statute.

The Court of Appeals held that the 11 NYCRR 65-3.16(a)(12) is valid and within the Superintendent's authority to issue and upheld the regulation pursuant to general administrative law principles.

The Court of Appeals further held that insurance carriers may withhold reimbursement from fraudulently licensed medical corporations and that the carriers "may look beyond the face of licensing documents to identify willful and material failure to abide by state and local law." Id. The defendants raised an issue with regard to the carriers' investigatory privileges, arguing that no-fault carriers will use this concept as a "vehicle for delay and recalcitrance." In rejecting this argument, the Court of Appeals stated :

> Indeed, the Superintendent's regulations themselves provide for agency oversight of carriers, and demand that carriers delay the payment of claims to pursue investigations solely for good cause [see, 11 NYCRR 65-3.2(c). In the licensing context, carriers will be unable to show "good cause" unless they can demonstrate behavior tantamount to fraud. Technical violations will not do. [...] We expect, and the Legislature surely intended, vigorous enforcement action by the Superintendent against any carrier that uses the licensing-requirement regulation to withhold or obstruct reimbursements to nonfraudulent health care providers.

State Farm Mutual Auto. Ins. Co. v. Mallela, 4 N.Y.3d 313 at 322, 794 N.Y.S.2d 700 at 703.

The Court went on to state that something minor, such as a "failure to hold an annual meeting, pay corporate filing fees or submit otherwise acceptable paperwork on time" does not rise to the level of fraud so as to justify the denial of payment due to fraudulent incorporation.

The Court of Appeals declined to consider the issue of whether, if a health care provider is found to be a fraudulently incorporated entity, the no-fault carrier would be able to recover money already paid out under theories of fraud or unjust enrichment.

Does an Insurer have to Show "Good Cause" to Obtain Discovery of Relating to a Health Care Providers' Incorporation ?

After State Farm Mutual Auto. Ins. Co. v. Mallela, courts have been dealing with the question of whether the Court of Appeals' decision requires no-fault carriers to show "good cause" before seeking discovery on the issue of whether a medical care provider asserting a no-fault claim as an assignee is fraudulently incorporated.

Andrew Carothers v. Insurance Co., 13 Misc.3d 970, — N.Y.S.2d —, 2006 WL 2714429 (N.Y. City Civ. Ct.), held that Mallela does not require a no-fault carrier to show "good cause" by demonstrating "behavior [on a medical provider's part] tantamount to fraud" before it can obtain discovery on the issue of fraudulent incorporation. The court pointed out that Mallela stated that 11 NYCRR 65-3.2[c] requires an insurer to only delay no-fault payments and pursue investigations for "good cause". The court noted that this regulation (and the dicta in Mallela pertaining thereto) deals with a no-fault insurer's claim practice–the investigation of the claim *prior* to the filing of a lawsuit. The court stated, "[i]t is apparent to this court that the investigations the court was discussing in Mallela are those conducted by insurers during the claims process in accordance with their entitlement under the regulatory scheme to seek verification of claim and not those conducted by litigants during the discovery process." Id. At 2.

The court further held that once a lawsuit arising out of a no-fault claim is commenced, discovery is governed by the rules set forth in New York's CPLR. Pursuant to CPLR § 3101(a), a party is entitled to disclosure of "all matter material and necessary in the prosecution or defense of an action". Accordingly, the scope of discovery is governed by this standard. Andrew Carothers v. Insurance Co., 13 Misc.3d 970, — N.Y.S.2d —.

Accordingly, pursuant to Andrew Carothers v. Insurance Co., an insurer need not show "good cause" by demonstrating fraud on the part of the medical care provider before the insurer is entitled discovery relating to an alleged fraudulent incorporation. However, the insurer, pursuant to the CPLR, will have to show that the discovery is material and necessary to the defense and/or prosecution of the action. The court in Andrew Carothers v. Insurance Co., 13 Misc.3d 970, — N.Y.S.2d —, 2006 WL 2714429 (N.Y. City Civ. Ct.) was careful not to broaden the scope of discovery too much, and further went on to discuss various considerations that the court should focus on in exercising its broad power over discovery. Specifically, the court noted that no-fault litigation usually deals with smaller amounts of money and encouraged the use of protective orders to limit discovery in these cases. The court emphasized the need to consider the intrusiveness of the discovery request, the merits of the claim, etc.

The court in Andrew Carothers v. Insurance Co., 13 Misc.3d 970, — N.Y.S.2d —, 2006 WL 2714429 (N.Y. City Civ. Ct.) ultimately held that the carriers were entitled to depose Dr. Carothers on the issue of fraudulent incorporation. The court noted that Dr. Carothers was the "best witness" to provide the relevant information. The court held that the information relative to the fraudulent incorporation was a complete defense to the payment of no-fault benefits and, pursuant to CPLR 3101(a), was "material and necessary" to the outcome of the litigation. Further, the court found that the no-fault insurers successfully demonstrated that they were not merely on "a fishing expedition" by putting forth evidence that other prior facilities operated by the same individuals were fraudulently incorporated.

Other courts have also applied the "material and necessary" test pursuant to CPLR 3101(a), rather than applying a "good cause" standard. *See*, Midborough Acupuncture, P.C. v. State Farm Ins. Co., 13 Misc.3d 58, 823 N.Y.S.2d 822 (Sup. Ct. App. Term 2006) (holding that State Farm was entitled to discovery on the issue of fraudulent incorporation where the information sought was "material and necessary" pursuant to CPLR 3101(a)); A.B. Medical Services PLLC v. Utica Mutual Insurance Co., 11 Misc.3d 71, 813 N.Y.S.2d 845 (Sup. Ct. App. Term 2006) (holding that health care providers must respond to no-fault carriers' discovery requests pertaining to corporate information were not palpably improper or privileged); S.K. Medical Services v. New York Central Mutual Fire Ins., 11 Misc.3d 1086(A), 819 N.Y.S.2d 852 (N.Y. City Civ. Ct. 2006) (discovery demands pertaining to health care providers' corporate structure were proper).

Failure to Timely Deny No-Fault Claim Does Not Preclude Insurer's Fraudulent Incorporation Argument

Failure to deny a no-fault claim within the 30-day claim determination period precludes the no-fault carrier from raising most defenses against the claimant and/or assignee. *See*, Presbyterian Hosp. in City of New York v. Maryland Cas. Co., 90 N.Y.2d 274, 660 N.Y.S.2d 536 (1997).

Failure to timely deny the no-fault claim, however, does not preclude the insurer's defense that the claimant is fraudulently incorporated, and therefore not eligible for reimbursement pursuant to 11 NYCRR 65-3.16(a)(12). A.B. Medical Services, PLLC v. Prudential Property & Cas. Ins. Co., 7 Misc.3d 14 (N.Y. Sup. App. Term 2005); Midborough Acupuncture, P.C. v. State Farm Ins. Co., 13 Misc.3d 58, 823 N.Y.S.2d 822 (Sup. Ct. App. Term 2006); AVA Acupuncture v. ELCO Administrative Services, 11 Misc.3d 1079A, 814 N.Y.S.2d 889 (Table), 2006 WL 286854 (N.Y. City Civ. Ct. 2006); Citywide Social Work and Psychological Services v. State Farm Mutual Auto Ins., 13 Misc.3d 1215A, 824 N.Y.S.2d 753 (Table), 2006 WL 2787007 (N.Y. Dist.Ct. 2006); First Help Acupuncture v. State Farm Ins. Co., 12 Misc.3d 130A, 819 N.Y.S.2d 209 (Table), 2006 WL 1541272 (Sup. Ct. App. Term 2006).

Retroactive Effect of 11 NYCRR 65-3.16(a)(12)

There remains an issue as to whether the insurance regulation prohibiting no-fault reimbursement payments to a fraudulently incorporated entity, 11 NYCRR 65-3.16(a)(12), is retroactive. 11 NYCRR 65-3.16(a)(12) was effective April 4, 2002. The Court of Appeals in Mallela did not address this issue directly and lower courts have been split on the issue of whether to apply the regulation to no-fault claims that accrued before the effective date.

In A.T. Medical, P.C. v. State Farm, 10 Misc.3d 568, 809 N.Y.S.2d 392 (N.Y. Civ. Ct. 2005), the court held that section 65-3.16(a)(12) of the insurance regulations was retroactive because that provision merely codified a requirement that had previously been required. The court gave deference to the Insurance Department's own interpretation of the regulation, which had been quoted by Michael Billy, Jr. & Skip Short in *Insurance Department Regulations to Stem Fraudulent No-Fault Claims Upheld by Court of Appeals* 76-JAN NY St. B.J. 40 [2004]. Citing to this article, the court stated that the Insurance Department had already provided its opinion that the new regulation had been added merely "to clarify that a health care provider must be properly licensed to be eligible for reimbursement under no-fault." Id. at 571. The court followed the agency's interpretation and held that the requirements codified in 11 NYCRR 65-3.16(a)(12) applied to the filing of no-fault claims by fraudulently incorporated entities before April 2, 2002 (the effective date of the regulation). *See also*, Multiquest PLLC v. Allstate Ins. Co., 9 Misc. 3d 1031, 805 N.Y.S.2d 255 (Civ. Ct. Queens 2005).

On the other hand, in Metroscan Imaging, P.C. v. GEICO, 13 Misc.3d 35, 823 N.Y.S.2d 818 (Sup. Ct. App. Term 2006), the court held that 11 NYCRR 65-3.16(a)(12) is not retroactive and does not apply to claims for no-fault benefits accruing before April 2, 2002. The court stated, "we read Mallela as holding that the promulgation of 11 NYCRR 65-3.16(a)(12) by the Superintendent of Insurance altered the common law prospectively such that an insurance carrier may maintain a cause of action against a fraudulently incorporated medical service corporation to recover assigned first-party no-fault benefits which were paid by the insurer to such medical service corporation [only] *after* the regulation's effective date." Id.

The Court of Appeals has not dealt with this issue directly, yet, and the lower courts remain split on the issue.

Generally, Requirement that No-Fault Assignee be a Licensed Health Care Provider

As discussed above, an assignee of no-fault benefits must be licensed to practice medicine pursuant to 11 NYCRR 65-3.16 and State Farm v. Mallela, 4 N.Y.3d 313, 794 N.Y.S.2d 700 (2005).

In Proscan v. Radiology of Buffalo v. Progressive Casualty Insurance Co., 12 Misc.3d 1176A, 820 N.Y.S.2d 845 (Table), 2006 WL 1815210 (N.Y. City Ct. 2006), the court held that Proscan Radiology was not licensed to practice medicine in New York and, therefore, cannot be eligible for no-fault reimbursement pursuant to 11 NYCRR 65-3.16. The court did make a distinction, however, between the situation in Mallela, where the health care provider was fraudulently incorporated, and the current situation, where the health care provider was not licensed to practice medicine due to a "technical violation". The court noted that all principals in the company were licensed to practice medicine. Although the court based its holding on other facts, in dicta, the court stated :

> Under this type of fact pattern, fairness would seem to dictate that Proscan Imaging simply be allowed 60 days to apply, pay the required fees and be issued a license in order for it to maintain its claim, much like unauthorized foreign corporations seeking to maintain an action in New York once their corporate status is discovered in the middle of litigation." Id.

In Rockaway Blvd. Medical P.C. v. Progressive Ins., 802 N.Y.S.2d 302 (N.Y. Sup. 2005), the court held that a "provider" of medical services for purposes of 11 NYCRR 65.15(j)(l) does not include a billing provider who seeks no-fault reimbursement for services which were rendered by an independent contractor, and not by its own employees. Accordingly, no-fault reimbursement of billing provider was improper. *See also,* A.B. Medical Services PLLC v. Liberty Mut. Ins. Co., 9 Misc.3d 36 (N.Y. Sup. App. Term. 2005).