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How Far Will 'Mallela III' Be Extended?

Lower courts differ in interpreting the decision's effect on medical providers' ineligibility for no-fault insurance reimbursement.

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IN JUNE 2004, the U.S. Court of Appeals for the Second Circuit certified a question dealing with no fault health insurance payments to the New York Court of Appeals, which that Court answered in *State Farm Mutual Automobile Insurance Co. v. Mallela*[1] *("Mallela III").* Although the Court of Appeals answered the certified question, several issues have arisen from the decision as to its effect and scope. These issues, including the retroactivity of the decision, are being litigated vigorously; lower courts have been split on the answers to some questions.

A significant unresolved question arising out of *Mallela III* is whether 11 NYCRR 65-3.16(a)(12), the Insurance Department regulation at the heart of the litigation, can be relied upon by insurance carriers to deny claims for payment filed before the effective date of the regulation. New York lower courts have reached various conclusions on this retroactive issue, and, therefore, it appears inevitable that the Appellate Divisions or the Court of Appeals will be called upon to address the issue.[2]

In addition to retroactivity, there is also an issue of how much latitude insurance carriers have under *Mallela III* to investigate the corporate structure of medical practices. As discussed below, *Mallela III* provides insurance carriers power to investigate the medical provider's incorporation documents. Under *Mallela III*, an insurance carrier may reject a provider's claim if the provider fraudulently incorporated a professional medical corporation and thus violated New York state law.

If insurance carriers have the ability to investigate incorporation documents in this regard, they are also likely to claim power to investigate other potential violations of other statutes and regulations, including those governing professional misconduct. It will, once again, be left to the courts to define the scope of the *Mallela III* investigative power.

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'Mallela III' Background

In the action underlying *Mallela III*, State Farm Insurance Company sought a declaratory judgment holding that it did not have to pay the defendant medical practice's claim for payment because of defendant's fraud.[3] State Farm alleged that defendant had fraudulently incorporated a professional corporation (P.C.) because the true owner of the corporation was not a licensed doctor.[4]

The Second Circuit found New York law unclear and certified the following question to the New York Court of Appeals: "[i]s a medical corporation that was fraudulently incorporated under N.Y. Business Corporation Law §§1507, 1508, and N.Y. Education Law §6507(4)(c) entitled to be reimbursed by insurers, under New York Insurance Law §§510 et seq., and its implementing regulations, for medical services rendered by licensed medical practitioners?"[5]

The New York Court of Appeals decided that fraudulently incorporated professional corporations were not entitled to reimbursement by insurers. The Court held "that on the strength of [11 NYCRR 65-3.16(a)(12)], carriers may look beyond the face of licensing documents to identify willful and material failure to abide by state and local law."[6] The Court looked to 11 NYCRR 65-3.16(a)(12) because, under N.Y. Insurance Law §5102 et seq., no-fault carriers must reimburse patients for "basic economic loss" and 11 NYCRR 65-3.16(a)(12) provides an exclusion from basic economic loss. This regulation provides:

> [a] provider of health care service 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.[7]

The Court of Appeals determined that the Superintendent had authority to promulgate 11 NYCRR 65-3.16(a)(12) and the regulation was neither irrational nor unreasonable, and, therefore, the regulation was valid.

Under 11 NYCRR 65-3.16(a)(12), insurance carriers may examine whether a professional corporation was fraudulently incorporated prior to the insurance carrier having to pay an insurance claim.[8] The Court stated, however, that the investigation had to be based upon "good cause," and that "technical violations" are not enough to qualify as "good cause."[9] The Court also stated that insurance carriers are not permitted to abuse the "truth-seeking opportunity that 11 NYCRR 65-3.16(a)(12) authorizes."[10]

The Retroactivity Issue

The regulation relied upon in *Mallela III*, 11 NYCRR 65-3.16(a)(12), has an effective date of April 4, 2002. Therefore, for any claim arising after April 4, 2002, the insurance carrier may examine the structure and operation of the professional corporation to determine if it is fraudulently created.

However, for claims arising prior to April 4, 2002, the *Mallela III* court did not clearly answer whether 11 NYCRR 65-3.16(a)(12) applies, explaining that "no cause of action for fraud or unjust enrichment would lie for any payments made by the carriers before [the effective date]."[11] New York lower courts have reached differing interpretations of this language.

In a recent case interpreting *Mallela III*, *Allstate Insurance Co. v. Belt Parkway Imaging, P.C.*,[12] the court stated that *Mallela III* "left open the issue of whether the insurers could withhold payment (as opposed to recover payments already made) for unpaid claims that accrued prior to April 4, 2002."[13]

In the court's analysis, decisions were cited holding both that insurance providers could,[14] and cannot,[15] withhold payments for unpaid claims accruing prior to April 4, 2002. The *Belt Parkway Imaging* court found the regulation to be retroactive, and, therefore, the insurance provider could withhold payment to a fraudulently incorporated professional corporation.

Retroactive Application Appropriate. In the line of cases holding 11 NYCRR 65-3.16(a)(12) to be applicable retroactively, courts have held that the new regulation merely clarified existing law.[16]

In *A.T. Medical, P.C.*, the court cited the Insurance Department's opinion that

"§65-3.16(a)(12) of the new regulation had been added 'to clarify that a health care provider must be properly licensed to be eligible for reimbursement under no-fault.'"[17] Therefore, although 11 NYCRR 65-3.16(a)(12) became effective on April 4, 2002, professional corporations were required to comply with the licensing regulations before the effective date and if they failed to comply, insurance companies could have refused to reimburse insurance claims.

Courts have also relied upon public policy in concluding 11 NYCRR 65-3.16(a)(12) should apply retroactively. In *Mallela III*, the Court decided that the policy considerations of protecting insurers from fraud outweighed the public policy considerations associated with speedy resolution of no-fault claims. The court in *Belt Parkway Imaging* believed that a retroactive application of 11 NYCRR 65-3.16(a)(12) "comports with the policy choices of the Court of Appeals."[18]

In examining public policy, courts have acknowledged how legislation is presumed to have prospective application unless the legislation clearly indicates a preference for a retroactive effect,[19] but nevertheless concluded that 11 NYCRR 65-3.16(a)(12) applied retroactively because it was introduced to clarify existing law and it was necessary to combat a dramatic increase in fraudulent no-fault claims.[20]

Additionally, in *Multiquest, PLLC v. Allstate Insurance Co.*,[21] the court determined that the intent of *Mallela III* was to have 65 NYCRR 3-16(a)(12) apply retroactively. The court cited *Metroscan Imaging, PC*, and stated that if the regulation only applied to claims maturing after April 4, 2002 it would be "'illogical' and would negate the intent of the *Mallela III* Court."[22]

Retroactive Application Inappropriate. In the line of cases denying retroactive application of 11 NYCRR 65-3.16(a)(12), the courts rely upon a fundamental principle that "retroactivity will be applied only where the language of the law expressly allows for such an application."[23]

These courts then look to the language of 11 NYCRR 65-3.16(a)(12) and do not find specific language stating that the rule should be applied retroactively. Therefore, the courts conclude that insurers must pay the insurance claims of providers that accrued prior to April 4, 2002. In reaching this conclusion, one court noted it was "mindful of the extent that fraud has undermined the policy of No-Fault Law,"[24] but the regulation could not be applied retroactively.

In addition to the Insurance Superintendent's failure to include retroactive language in 11 NYCRR 65-3.16(a)(12), in *Multiquest, PLLC* Judge Charles J. Markey noted the importance of the *Mallela III* court's failure to provide a ruling on retroactivity.[25] He stated that "if the Court of Appeals had wanted to provide a rule of retroactivity, it was fully informed of the issue at the oral argument…and could have determined the issue in its opinion."[26]

What's Next?

In *Mallela III*, the Court stated that insurance carriers cannot abuse the power to investigate licensing documents, and carriers must have "good cause" to initiate an investigation. To show "good cause," the insurance carrier must "demonstrate behavior tantamount to fraud," and technical violations are insufficient.[27]

In *AIU Insurance Co. v. Deajess Medical Imaging P.C.*,[28] the court denied the insurance carrier's attempt to extend *Mallela III*. Here, the carrier contended that the medical provider was fraudulently incorporated and that the true owner, who allegedly controlled the practice, was not a licensed physician. Additionally, the carrier alleged that the named owner did not control the professional corporation because he contracted with controlling management companies that received up to 89 percent of the total revenue of the practice.

In denying the attempt to extend *Mallela III*, the court stated that the carrier was seeking a ruling "to establish a judicial guideline, or framework, of how much (or how little) the health care provider's profit margin should be, and if that guideline is 'violated' then that corporate framework is a fraudulent one."[29] The court also refused to "mandate that a health care provider be personally involved in areas of his practice where he has not demonstrated expertise—equipment leasing, premises rental and maintenance, office management, etc."[30]

In order to avoid being embroiled in these types of disputes, medical providers should ensure that they comply with all state laws.

Several courts since *Mallela III* have approved insurance carriers' discovery demands related to medical providers' corporate structure and licensing status, even when the insurance company failed to pay or deny the claim in the 30-day prescribed period.[31]

In *SK Medical Services, P.C. v. N.Y. Central Mutual Fire Insurance Co.*,[32] the court stated that the insurance provider "is entitled to compliance with its various discovery demands to the extent they seek information regarding plaintiff's corporate structure and licensing status, and that until such discovery is provided, [the medical provider's] cross-motion for summary judgment must be denied as premature."[33] The court permitted the insurance company to raise the "defenses recognized in *Mallela [III]*" even if they did not timely deny the claim.[34]

In addition to using *Mallela III* in discovery, insurance companies may begin to seek declaratory judgments holding a provider's willful and material failure to abide by any state or local law is sufficient to refuse payment of a claim. It is unclear whether *Mallela III* permits insurance carriers to investigate violations of statutes unrelated to incorporation and licensing; however, it is likely they will contend *Mallela III* allows such inquiries.

Therefore, medical providers must ensure that they comply with all state laws, including laws governing corporate formation, referral agreements and professional misconduct, to avoid being embroiled in such disputes. As courts decide the retroactive issue, they will, no doubt, also be faced with the question of how broad the insurance carrier's investigation of medical providers may extend. Clearly, the full effect of *Mallela III* remains to be seen.

1. 4 N.Y.3d 313 (2005).
2. See *Better Health Medical PLLC v. Empire/Allcity Ins. Co.*, 11 Misc.3d 1075(A)(City of N.Y. Civil Ct. 2006) ("There is much debate as to whether a fraudulently licensed medical provider who provided services before April 5, 2002, is entitled to payment and the lower courts have ruled inconsistently. The Court of Appeals has yet to rule on this issue.").
3. *State Farm Mutual Automobile Insurance Co. v. Mallela*, 372 F.3d 500, 503 (2d Cir. 2004).
4. *Mallela*, 4 N.Y.2d at 319-20 (State Farm alleged unlicensed defendants paid physicians to use their names on incorporation paperwork and defendants operated practice through management company).
5. *Mallela*, 372 F.3d at 510.
6. *Mallela*, 4 N.Y.2d at 321.
7. 11 NYCRR 65-3.16(a)(12).
8. See *Mallela*, 4 N.Y.2d at 321; see also *Tahir v. Progressive Casualty Insurance Co.*, 2006 WL 1023934 (N.Y. City Civ. Ct. 2006) ("[N]ot being a properly licensed health services facility truly poses an issue of not being eligible to receive reimbursement, rather than fraud.").
9. *Mallela*, 4 N.Y.2d at 322.
10. Id.
11. Id.
12. 2006 N.Y. Slip Op. 26024 (Sup. Ct. N.Y. Co. 2006).
13. Id. at *4 (adding *Mallela III* "held that (1) the insurance companies could withhold payment for medical services that fraudulent incorporated enterprises provided and to which patients have assigned their claims; (2) the insurance companies could bring actions for fraud and unjust enrichment to recover payments made on or after the regulation's effective date of April 4, 2002, by implication; and (3) no cause of action for fraud or unjust enrichment would lie for any payments that the insurance carriers made prior to the regulation's effective date of April 4, 2002").
14. See *Metroscan Imaging PC v. GEICO Ins. Co.*, 8 Misc. 3d 829 (Civ. Ct. Queens Co. 2005); *Multiquest, PLLC v. Allstate Ins. Co.*, 9 Misc. 3d 1031 (Civ. Ct. Queens Co. 2005); *A.T. Med., P.C. v State Farm Mut. Ins. Co.*, 10 Misc. 3d 568 (Civ. Ct. Queens Co. 2005).
15. See *Multiquest, PLLC v. Allstate Ins. Co.*, 2005 WL 3274885 (Civ. Ct. Queens Co. 2005); *Multiquest, PLLC v. Allstate Ins. Co.*, 10 Misc. 3d 1061 (Civ. Ct. Queens Co. 2005); *Multiquest, PLLC v. Allstate Ins. Co.*, 2005 WL 3626771 (Civ. Ct. Queens Co. 2005).
16. *Belt Parkway Imaging*, 2006 N.Y. Slip Op. 26024 at *5.
17. *A.T. Medical*, 10 Misc.2d at 568 (citing Michael Billy Jr. & Skip Short, "Insurance Department Regulations to Stem Fraudulent No-Fault Claims Upheld by Court of Appeals," 76-JAN NY St. B.J. 40 (2004)).
18. *Belt Parkway Imaging*, 2006 N.Y. Slip Op. 26024 at *5; see also *Metroscan Imaging*, 8 Misc.3d at 835 ("*Mallela III* court placed protection against fraud squarely ahead of speedy resolution of no-fault provider claims").
19. *A.T. Medical*, 10 Misc.3d at 568.
20. See *Metroscan Imaging*, 8 Misc.3d at 835 ("Corporations formed specifically to defraud the public and abuse the public trust must not be allowed to reap windfall profits, even in the face of competing compelling public policy.").
21. 9 Misc.3d at 1034.
22. 9 Misc.3d at 1034.
23. *Multiquest, PLLC*, 2005 WL 3626771 at *5; see also *Multiquest, PLLC*, 2005 WL 3274885 at *2 (explaining rule applies retroactively only if specifically required).
24. *Multiquest, PLLC*, 2005 WL 3626771 at *5
25. *Multiquest, PLLC*, 2005 WL 3487785 at *1.
26. Id.
27. *Mallela*, 4 N.Y.3d at 322; see also *Ava Acupuncture P.C. v. Elco Administrative Services Co.*, 10 Misc.3d 1079(A)(N.Y. City Civil Ct. 2006) (finding failure to remit triennial statement and fee insufficient to establish medical provider's ineligibility to receive reimbursement under *Mallela III*).
28. New York Law Journal Feb. 10, 2006, at 22 (col. 1)(Sup. Ct. Nassau Co. 2006).
29. Id.
30. Id.
31. See *A.B. Medical Services PLLC v. Utica Mutual Insurance Co.*, 2006 WL 461513 (Sup. Ct. App.Term 2006) (explaining insurance provider precluded from raising most defenses because failure to pay or deny claim within 30-day period proscribed by 11 NYCRR 65-3.8(c)).
32. 2006 WL 1094592 (N.Y. City Civ. Ct. 2006).
33. Id. at *2.
34. Id. at *2 ("There is no logical reason to distinguish an insurer's entitlement to discovery regarding [] non-waiveable defenses and the type of defenses recognized in *Mallela [III]*").