

# Navigating Scrutiny Of Friendly Professional Corps. In Calif.

By **John Saran, Kenneth Yood and Shalyn Watkins** (July 2, 2024)

The friendly professional corporation model is currently being challenged in California on multiple fronts — new legislation and regulations, court decisions interpreting existing legislation and regulation, and new policies and interpretations from governmental and private actors.

The following discusses these challenges and provides guidance for current and prospective participants to these investments and arrangements in California. Strategic planning and implementation should be carefully scrutinized on a proactive basis to avoid the possibility of difficult adjustments being made on a reactive basis.

## The Friendly Professional Corporation

The friendly professional corporation model allows medical groups and physician organizations to access affordable capital, whether from private equity, other nonphysician investors, or lenders, and provide equity-based compensation packages for their nonclinical personnel, while also allowing clinicians to focus on providing high quality care, all in compliance with a state's corporate practice of medicine, CPOM, prohibitions.[1]

Through the use of a contractual arrangement — the management services agreement — the management services organization, or MSO, provides nonclinical and administrative services, e.g., space, equipment, back-office personnel and support, etc., to the professional corporation in exchange for a fee that is commensurate with the value of the services furnished.

In addition, many MSOs may agree to provide working capital loans to the professional corporation to fund the payment of the professional corporation's expenses, including physician compensation; those MSOs are then dependent on the professional corporation to generate sufficient revenue, in excess of the professional corporation's expenses, to recoup the capital outlay made for the benefit of the professional corporation and its employees.

Often, the MSO, and the professional corporation and its owner, enter into a continuity agreement, or similar type of agreement, such as a directed transfer agreement or stock transfer restriction agreement.

Such an agreement is intended to provide for continuity of ownership and operation of the professional corporation and patient care for the benefit of all stakeholders, including patients, if certain defined events happen that could otherwise harm continuity of care or the success of the arrangement for the parties and other stakeholders.

The textbook use case for a continuity agreement would be to address successorship in the event that the professional corporation owner dies, loses their medical license, is placed on the U.S. Department of Health and Human Services' Office of Inspector General's exclusion



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list or otherwise becomes legally disqualified from continuing to own the professional corporation.

In those cases, a typical continuity agreement might provide for the MSO to assist the professional corporation in identifying a willing and able physician who would then purchase the deceased or disqualified owner's shares in the professional corporation.

Sometimes, the professional corporation owner may, in addition to their clinical duties for the professional corporation, also serve as an officer, director or consultant for the MSO.

Because this role would require the professional corporation owner to agree to provide the MSO with nonclinical services, separate and apart from any clinical role that the owner has for his or her own professional corporation, the MSO often agrees to separately compensate the owner for as long as he or she serves in that nonclinical role at the MSO.

State law varies in the relative degree of sensitivity to continuity agreements and similar types of agreements that contemplate the transfer of professional corporation ownership.

Even within the same state, court decisions can vary depending on the facts of the case presented, the breadth of the language contained in the applicable agreement, and the presence or absence of safeguards for protecting clinical autonomy.

### **Current Challenges to the Friendly Professional Corporation Model and Private Equity Participation in Healthcare**

Currently, there are two primary forums in which various actors have sought to challenge the friendly professional corporation model in California and, in turn, the participation of private equity in the provision of healthcare in the state: judicial and legislative.

The underlying complaint in *American Academy of Emergency Medicine Physician Group Inc. v. Envision Healthcare Corp.*, as filed in the U.S. District Court for the Northern District of California on Dec. 20, 2021, claims that Envision Healthcare uses shell business structures to retain de facto ownership of emergency room staffing groups in violation of California's CPOM prohibition.

On the legislative front, A.B. 3129 — which was introduced in the California Assembly in February and was referred to the California Senate Health and Judiciary committees on May 29 — would, if enacted, require private equity groups and hedge funds to receive consent from the California attorney general before transacting business with healthcare facilities or provider groups.[3]

A.B. 3129 would also prohibit some management services arrangements between private equity groups, hedge funds and physician practices.[4] On June 19, an amended version of A.B. 3129 was released.

### **Art Center Holdings**

One pertinent case, *Art Center Holdings Inc. v. WCE CA Art LLC*, involves several affiliated defendants that make up WCE, an MSO.

Pursuant to a management services agreement between the parties, WCE provides management and administrative services to Southern California Reproductive Center, a California professional corporation that provides women's health, reproductive and fertility

services. SCRC and various affiliated practice entities and doctors are the plaintiffs.

One of the plaintiffs, Mark Surrey, owned 100% of SCRC and signed a continuity agreement with SCRC and WCE. Additionally, Surrey signed a consulting agreement to provide nonclinical consulting services to WCE.

Among other things, the continuity agreement contemplated that if the consulting agreement were terminated, Surrey would relinquish his shares in SCRC to another licensed physician to be identified by WCE. By its terms, the consulting agreement could be terminated by WCE at any time for any reason, which would then trigger the procedures under the continuity agreement.

In 2020, BC Partners acquired WCE and its affiliated companies. Soon thereafter, a number of disputes arose between SCRC and WCE. The plaintiffs allege the MSO mismanaged the business operations of the practice, including by undercollecting accounts receivable, firing or causing nonclinical staff to resign, and underinvesting on equipment and other nonclinical expenses.

The plaintiffs further allege that this mismanagement caused declining compensation for physicians and, as a result, clinical staffing shortages. Moreover, the plaintiffs allege that the MSO asked the professional corporation to terminate some of its physicians, and when the professional corporation refused to do so, the MSO terminated the consulting agreement as a pretext to justify changing ownership of the professional corporation through the procedures set forth in the continuity agreement.

The plaintiffs filed their complaint in Los Angeles County Superior Court, citing five causes of action: (1) breach of contract, (2) breach of the implied covenant of good faith and fair dealing, (3) gross and negligent mismanagement, (4) conversion and (5) intentional interference with prospective economic advantage.

They sought declaratory relief, accounting, injunctive relief, and punitive and exemplary damages. In the middle of the litigation, the plaintiffs filed a motion requesting that the court appoint a receiver for SCRC to transfer control back to Surrey to ensure compliance with legal and regulatory standards.

### ***Court's Decision***

On April 30, the Los Angeles County Superior Court ultimately granted the motion appointing the receiver solely for the purpose of transferring control of SCRC back to Surrey.

The court's reasoning for granting the receivership motion was that the plaintiffs met their burden of establishing that the Receivership Entities are in danger of being lost, removed or materially injured. The continued operation of SCRC — where a non-physician, WCE, directly controls the physicians in charge of SCRC — would be against public policy and subject the parties to the risk of professional and criminal repercussions.

In short, the court found that WCE used the continuity agreement as a means to control the firing of the professional corporation's physicians, which violated California's CPOM laws.

When analyzing whether WCE had engaged in the unlawful practice of medicine the court looked to precedent in three other cases and relied on the California Medical Board's guidance to practitioners.[5]

Ultimately, the court found that the forced transfer terms in the continuity agreement provided WCE with "undue control of a medical practice" that violated California law. The hiring, firing and disciplining of clinical personnel was supposed to be an undisputed right reserved to Surrey.

The court stated, "WCE had the contractual ability to remove Dr. Surrey from his position in SCRC if they disagreed with his actions. If they have such a right, then WCE necessarily had undue control over the doctor-owner of SCRC, even if they did transfer SCRC to another California-licensed doctor."

Accordingly, the court found that the exercise of the broad terms in the continuity agreement and consulting agreement to be violative of California law. In dicta, the court goes further to suggest that even the mere presence of the continuity agreement is violative of California law.

However, the court refused to grant a receivership over the nonclinical business, which implied that WCE could retain control over the nonclinical assets needed to operate the practice. As a practical matter, this means that the continued viability of the practice and its ability to serve patients will likely depend on whether WCE and Surrey can reach a deal, since each still depends on the success of the other.

WCE has since appealed the ruling to the California Court of Appeal, Second Appellate District, but for the time being, the court appointed a receiver and the lawsuit continues.

### **Where MSOs in California Go From Here**

#### ***Evaluate management services agreements and operations to ensure that MSOs steer clear of clinical decision making.***

An MSO must limit its role in the management of a medical practice to administrative aspects of the business, while the practice remains solely responsible for all clinical functions, including all clinical decision making relating to patient care.

In California, the medical board maintains well-known guidance that the hiring and firing of practice physicians is a clinical function to be reserved for the professional corporation. Even if an MSO desires for the professional corporation to terminate bad actors, e.g., a physician engaging in sexual harassment, it must still honor the line separating clinical and nonclinical decision making.

In practice, however, discerning the difference between a purely administrative function and one that crosses the line into the clinical realm may be difficult to accomplish with certainty. Therefore, it is imperative for participants in such arrangements to focus on medical board guidance when drafting and carrying out their obligations under MSAs.

#### ***Proactively agree on successor owners before issues arise.***

MSOs and professional corporations depend on one another's success and should, like all businesses, have a succession plan in place should something happen to key leaders within their respective organizations.

As a best practice, professional corporations should identify suitable and acceptable successor owners early — before they are needed — rather than rely solely on the MSO to

find a successor.

That way, a dispute that arises between an individual owner and the MSO or professional corporation can be addressed on its own terms, rather than escalating it into a challenge that could disrupt all parties' interests and the best interests of patients.

For example, a professional corporation could have two physician owners.

In addition, with multiple owners and agreed-upon internal procedures for resolving employment matters, professional corporations can be assured that clinical autonomy is safeguarded, and MSOs can be assured that the professional corporation has appropriate procedures to deal with bad actors, rather than leave it solely in the discretion of a single professional corporation owner, who may have a personal relationship with the bad actor or may themselves be the bad actor.

### ***Carefully craft continuity agreements.***

Whereas some have raised concerns as to whether a CPOM-compliant friendly professional corporation arrangement can include any type of continuity or equity transfer arrangement, the court in Art Center Holdings did not declare all such arrangements to be violative of the California CPOM prohibitions.

Instead, the court declared that the violation was the result of how such an agreement was utilized by a lay entity, the MSO, to influence a professional entity when making a clinical decision.[6]

Art Center Holdings does not represent a new criticism of the friendly professional corporation model or private equity transactions in healthcare, but the case serves as a reminder that separating clinical and nonclinical functions and carefully crafting continuity agreements and other safeguards is integral to complying with CPOM law in California.

Although such revisions may serve to lower CPOM risks for the parties, parties to such arrangements need to carefully consider the impact that the CPOM-focused revisions could have on the ability of the parties to engage in financial and tax consolidation — such consolidation often relying on the existence of the continuity arrangement.

By limiting the ability of the lay entity to effectuate a transfer of the professional entity's equity from one professional to another, the ability to consolidate for financial and tax purposes may be impaired.

Therefore, the parties may find themselves engaged in a delicate balancing act to meet both regulatory compliance and financial and tax goals. As always, balancing acts require a carefully considered, fact-specific analysis involving the parties and their respective legal and financial advisors.

### ***Implement other best practices for aligning interests.***

The friendly professional corporation model is not static. To the contrary, it has evolved — in some cases significantly — over the years and across state lines, all with the goal of improving access and quality of care, reducing the cost of capital and further aligning interests so that all stakeholders can succeed.

MSOs and professional corporations need to work together, collaboratively, to understand

and execute on best practices and lessons learned over the years from other companies. Simply recycling old agreements, and not paying attention to the evolution of the friendly professional corporation model, will put both MSOs and professional corporations, and all of their stakeholders, at a competitive disadvantage.

## **Conclusion**

In light of the ongoing scrutiny and challenges to private equity participation in the California healthcare marketplace generally and the use of the friendly professional corporation model and MSOs specifically, current or prospective participants to such investments and arrangements should take steps to ensure compliance with California's CPOM law and other healthcare-related rules and regulations.

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[1] <https://www.hklaw.com/en/insights/publications/2023/08/federal-bankruptcy-court-stays-envision-healthcare-litigation>.

[2] <https://www.hklaw.com/en/insights/publications/2021/09/nj-appellate-court-gives-dsos-a-much-needed-win>.

[3] [https://leginfo.legislature.ca.gov/faces/billStatusClient.xhtml?bill\\_id=202320240AB3129](https://leginfo.legislature.ca.gov/faces/billStatusClient.xhtml?bill_id=202320240AB3129)

[4] <https://www.hklaw.com/en/insights/publications/2024/03/private-equity-healthcare-transactions-under-scrutiny>; <https://www.hklaw.com/en/insights/publications/2024/06/new-bill-would-empower-california-ag-to-curtail-healthcare>.

[5] <https://www.mbc.ca.gov/Licensing/Physicians-and-Surgeons/Practice-Information/>.

[6] This decision is consistent with a New Jersey court decision that found a succession agreement not to violate the corporate practice of dentistry as long as the broader arrangement between the MSO and PC complied with New Jersey law. See <https://www.hklaw.com/en/insights/publications/2021/09/nj-appellate-court-gives-dsos-a-much-needed-win>.