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NY Appellate Court Issues Decision on Executive Compensation Order and Regulations

On June 22, 2017 – more than 4 years after the issuance of Executive Order (EO) 38 and regulations promulgated by 13 New York State agencies limiting the amount certain service providers could compensate executives and spend on administrative expenses – the New York State Appellate Division, Third Department, affirmed the judgment of the lower court in *LeadingAge New York, et al. v. Shah, et al*. Both courts upheld the Department of Health (DOH) regulation on executive compensation and administrative expenses generally, but struck down the compensation "soft cap" component. Applying the Court of Appeals' multi-factor analysis in *Boreali v. Axelrod*, the four-Justice majority concluded that "limit on administrative costs and executive compensation *paid for by state funds and state-authorized payments*, do[es] not violate the separation of powers doctrine." In contrast, the Court said that DOH exceeded its authority by imposing the soft cap and restricting executive compensation paid from non-state dollars. In a lengthy discussion of New York administrative law, the Court explained that "the soft cap provision cannot pass constitutional muster," as it violates the constitutional separation of powers doctrine. As a result, there is now a conflict between the Appellate Division's Third Department and Second Department, which previously upheld Governor Cuomo's Executive Order and DOH's implementing regulations.

Summary of EO 38 and Implementing Regulations

The EO 38 regulations promulgated in May 2013 limit the amount that Covered Providers, as well as certain subcontractors and agents of Covered Providers, may compensate executives, as well as the amount of administrative expenses that these entities incur. Generally, any individual or entity that contracts to provide services to, and for the benefit of, members of the public and, in exchange, receives "State Funds" or "State-authorized Payments" (SF/SAPs) that exceed $500,000, making up at least 30 percent of its total annual New York revenues, is a Covered Provider. DOH regulations further define Covered Provider as 20 types of entities, including hospitals, residential health care facilities, home health agencies, health maintenance organizations and certain other health insurers, long-term and AIDS care programs, hospices, assisted living residencies, and emergency service entities.

The 2013 regulations established a "*hard cap*" prohibiting Covered Providers from using SF/SAPs to provide compensation greater than $199,000 to any Covered Executive, as well as a "*soft cap*," which prohibits the Covered Executive from receiving more than $199,000 — regardless of the source of the funds — unless, the compensation: (1) is no greater than the 75th percentile of compensation provided to comparable executives affiliated with comparable providers, consistent with the findings in a compensation survey recognized by the Division of Budget; and (2) has been approved by the Covered Provider's board of directors or other governing body, including at least two independent directors or members. The administrative expense cap aspect of the regulations now require that at least 85 percent of the SF/SAPs that Covered Providers receive be spent on Program Services, as opposed to costs related to management and overhead that "cannot be directly attributed to program services."

Third Department's Analysis of EO 38 Regulations

In *LeadingAge New York, Inc., et al. v., Shah, et al.,* the Third Department conducted an analysis of EO 38, the DOH regulation, and the purportedly related Public Health Law provisions. The Court observed that EO 38 "directed DOH. . . [and other agencies], to promulgate regulations aimed at curbing 'abuses in executive compensation and administrative costs and ensur[ing] that taxpayer dollars are used first and foremost to help New Yorkers in need.'" The EO resulted in regulations "which imposed limits on administrative expenses and executive compensation of certain health care providers that receive state [funds] . . . (hereinafter the hard cap) . . . [and] also placed the same restrictions . . . [on] nontaxpayer funds, except in certain conditions (hereinafter the soft cap)," with some opportunities for waivers. The lower court held that "with the exception of the soft cap provision, the regulations at issue were a constitutional exercise of authority by DOH and are neither arbitrary nor capricious." In its June 2017 decision, the Appellate Division, Third Department reached the same conclusion.

Writing for the majority, Justice Peters relied heavily on the four pronged *Boreali* test that "courts [are] to consider when determining whether an agency has crossed the hazy 'line between administrative rule-making and legislative policy-making'". Here, the Court observed that DOH has broad statutory authority to regulate the use of public funds, enter into contracts, and "ensure the provision of 'high-quality medical care," particularly in the Medicaid program. Justice Peters acknowledged, however, that "none of the . . . statutes expressly authorize[] the creation of the administrative cost and executive compensation limits." Nonetheless, without evaluating the validity of the EO, the Court determined that authority exists for the EO 38 regulations, simply because they "are not inconsistent with the . . . statutory provisions or their underlying purpose of obtaining high-quality services with limited available funds." This novel legal analysis raises a significant administrative law question as to whether there must be any underlying statute supporting an agency regulation, or whether an agency's regulation may be valid as long as there is no conflicting statute.

Regardless, the majority concluded that "by attempting to regulate executive compensation from all sources, DOH was acting on its own ideas of sound public policy; venture[d] outside [its] legislative mandate to manage the efficient and effective use of taxpayer money for health care and related services; [and] has no special expertise in administering regulations governing overall executive compensation or competence in regulating corporate governance as much." Thus, although the hard cap survives each of the *Boreali* prongs, the soft cap violates the separation of powers doctrine and is invalid.

Notably, Justice Mulvey dissented, arguing that DOH acted in excess of its authority with respect to *the entire* executive compensation regulation, and that both the hard cap and soft cap should be struck down. Justice Mulvey also applied the *Boreali* test, but found that there is no statutory authority for the regulations; that although "the Legislature has conferred broad powers on DOH to administer funds for public health services," the regulations "represent an intrusion into the prerogative of that branch." Additionally, he argued that the regulation "is voidable as arbitrary and capricious, since DOH has furnished no evidence to establish any linkage between the costs paid by these providers for executive compensation and administration and the problem identified by the Governor in Executive Order."

Impact on Regulated Entities & Next Steps

As noted in the decision, the Third Department "part[ed] company with the Second Department [in] . . . find[ing] that . . . DOH exceeded its authority in adopting the soft cap portion of" the regulation. That means, as of today, the:

- Administrative Expenses Cap is enforceable against all entities.
  - There is no court that has rejected this aspect of the regulation.

- Executive Compensation Hard Cap is enforceable against all entities.
  - Despite the dissenting opinion in *LeadingAge*, both the Second Department and the Third Department have determined that this provision of the regulation is enforceable.

- Executive Compensation Soft Cap is unenforceable against the parties to the Third Department case.
  - It is unclear as to how DOH will handle this with regards to the rest of the state.

- Reporting obligations continue to apply to Covered Providers.

Although the Court of Appeals previously declined to grant the petitioners in the Second Department case leave for appeal, in light of the conflict created by the Third Department's ruling, it is likely that the EO 38 regulation issue will be heard by the State's highest court.

If you have any questions about the application of the regulations or have concerns as to whether your organization may be subject to the executive compensation and administrative expense limitations, please contact us.

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