

**Alert** | New York Government Law & Policy



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## **NY’s Highest Court Invalidates Executive Compensation “Soft Cap” but Upholds “Hard Cap”**

On Oct. 18, 2018, the New York Court of Appeals **struck down** a major component of the Department of Health (DOH) regulation limiting executive compensation paid to executives employed by health care providers that receive state funds. Specifically, the court invalidated the aspects of the DOH regulations promulgated pursuant to **Executive Order (EO) 38** that limit the amount certain service providers may compensate their executives from non-state dollars. However, the court found constitutional the aspects of those regulations that limit (i) the amount that “covered providers” may spend on administrative expenses and (ii) how state dollars may be spent on executive compensation. This final determination in the New York courts may have a major benefit for those service providers that receive significant non-government funding in addition to state dollars, but will have limited effect on those entities that substantially rely on Medicaid or other state-funded programs to operate. The Court of Appeals decision affirmed the New York lower courts (See GT Alert, “**NY Appellate Court Issues Decision on Executive Compensation Order and Regulations**,” June 26, 2017).

### **Summary of EO 38 and Implementing Regulations**

The EO 38 regulations promulgated by 13 New York state agencies in 2013 limit the amount that covered providers, as well as certain subcontractors and agents of covered providers, may compensate executives; they also limit the amount of administrative expenses such entities may 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 providers 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 residences, and emergency service entities.

The EO 38 regulations that apply to Covered Providers consist of three components:

1. An “administrative expenses cap,” which mandates that 85 percent of state funds paid to a covered provider be spent directly on program services and not administrative expenses;
2. An executive compensation “hard cap,” which directs that, absent a waiver, a covered provider may not use *state funds* for executive compensation in an amount greater than \$199,000; and
3. An executive compensation “soft cap,” which precludes providers from paying executive salaries over \$199,000 *regardless of funding source*, absent an exception or a waiver.

### **The Court’s Conclusions**

The Court of Appeals decision resolved two separate lawsuits: one brought by two trade associations representing managed care plans; the other brought by nursing homes, assisted-living programs, home care agencies, and trade associations representing those providers. All petitioners were challenging the constitutionality of the DOH EO 38 regulations. In an opinion written by Chief Judge DiFiore, the Court of Appeals upheld DOH’s administrative expenses cap and the executive compensation hard cap but struck down the DOH executive compensation soft cap.

The court concluded that DOH lacked the requisite statutory authority to promulgate the soft cap. The calculus with respect to the soft cap “differs significantly” from the hard cap because the soft cap “is not focused on the direct regulation of state health care funding, but instead seeks to correct a policy concern that is outside DOH’s power.” The court observed that DOH was not able to identify a statutory basis for the soft cap regulation. Instead, “with respect to the soft cap DOH appears to have envisioned an additional goal of limiting executive compensation as a matter of public policy and regulated to that end. . . . By attempting to control how an entity uses its private funding, DOH has ventured beyond legislative directives relating to the efficient use of state funds and into the realm of broader public policy concerns.”

In contrast, the court determined that the administrative expenses cap “was a valid exercise of DOH’s regulatory authority” and that the hard cap passed constitutional muster. After applying the four-part approach for separation of powers challenges established in *Boreali v. Axelrod*, the majority concluded that the hard cap was a proper exercise of DOH’s regulatory powers: “[t]he hard cap regulations are . . . directly tied to a specific goal dictated by the Legislature — to efficiently direct state funds toward quality medical care for the public. . . . The hard caps accomplish that goal . . . by limiting the extent to which state funds may be used for non-service-related salaries or disproportionately large administrative budgets, thereby channeling state funds toward the direct provision of services.”

### **What Does This Mean for Covered Providers?**

As a general matter, covered providers who function on a calendar-year basis do not need to file their next disclosure reports until June 2019. To the extent that the covered provider is subject to the DOH regulation – as opposed to a comparable regulation promulgated by one of the other 12 agencies – the covered provider is now permitted to pay a covered executive more than \$199,000 if the provider has access to resources unrelated to state dollars. Such covered providers are no longer be required to seek a waiver to make such payments. To the extent the covered provider is subject to EO 38 regulations promulgated by one of the other state agencies, the entity may wish to confirm that the state agency too

will no longer be enforcing the soft cap. That said, in light of the court's ruling, it is clear that no agency can justify the application of the soft cap. Those covered providers that rely exclusively on state funds or payments, however, will remain in the position of either having to pay their covered executives no more than \$199,000 or seek a waiver to make additional payments. All potentially covered entities are encouraged to seek guidance both from legal counsel and accounting advisors.

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