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NYS Court Invalidates Executive Compensation "Soft Cap" Regulation

On Nov. 13, 2015, the Albany County Supreme Court upheld New York Governor Cuomo's Executive Order regarding executive compensation and administrative expenses of certain service providers (EO 38), as well as several aspects of the EO 38 regulations promulgated by the New York State Department of Health (DOH), but struck down those provisions of the DOH regulation that prevented Covered Providers from using non-State dollars to pay Covered Executives more than $199,000. The Albany court is the third New York State trial court to rule on the validity of EO 38 and the DOH regulations promulgated pursuant to that executive order. Significantly, the Albany Supreme Court took a different approach than the two other courts which previously ruled on this issue. In contrast to the Nassau County court which wholly invalidated EO 38 and the subsequently promulgated regulations, and the Suffolk County court which upheld EO 38 and the regulations in their entirety, Albany's Acting Supreme Court Justice Denise Hartman took a middle approach.

Background: Restrictions Placed on Covered Providers

In May 2013, pursuant to EO 38, 13 State agencies promulgated regulations to limit the amount that certain for-profit and not-for-profit service providers could pay to executives, and the amount of administrative expenses that these organizations could incur. Most organizations deemed Covered Providers, and therefore subject to the regulations, were not required to comply with the restrictions until the 2014 fiscal year, and were not required to file any disclosure reports until late 2015.

The EO 38 regulations were drafted to apply to Covered Providers, as well as certain subcontractors and agents of Covered Providers. A Covered Provider is any individual or entity, whether for-profit or not-for-profit, that contracts with a relevant state agency to provide Program Services (services provided to, and for the benefit of, members of the public), if:

(i) the individual or entity receives an annual average payment of more than $500,000 in "State Funds" or "State-authorized Payments" (SF/SAPs) – i.e., payments that are disbursed pursuant to authorization from a state agency or other New York governmental entity – in exchange for providing "Program Services" "during the covered reporting period and the year prior," and

(ii) at least 30 percent of the provider's total annual New York revenues during the year prior to the relevant reporting period are derived from SF/SAPs.

Several of the agencies' regulations noted that when determining whether an individual or entity is a Covered Provider, funds received "directly from a managed care organization subject to the oversight of" the applicable state agency, shall be treated as receiving SF/SAPs, even though the funds are not directly from the state. The DOH regulations also limited the definition of Covered Provider to 20 types of entities, including hospitals, nursing homes, home health agencies, health maintenance organizations and certain other health insurers, residential health care facilities, long term and AIDS care programs, hospices, assisted living residencies, and emergency service entities.

The agencies' 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. Additionally, the regulations require that initially at least 75 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" (i.e., "administrative expenses"). This increased to 85 percent in 2015.

The regulations also authorized "waivers" of the limits on executive compensation and administrative expenses upon a showing of "good cause," set forth the criteria to be used in granting or denying waivers, and required that any waivers granted be approved by both DOH and the Division of the Budget. Many Covered Providers applied for these waivers in 2015.

Litigation – Split Outcomes

Since the final adoption of the regulations, organizations have filed lawsuits in three different counties challenging the validity of the regulations and the underlying Executive Order. Although all of the trial courts have now ruled on these challenges, the impact of these decisions is yet to be seen because the courts' findings were inconsistent.

In April 2014, a Nassau County Supreme Court judge issued a decision in *Agencies for Children's Therapy Services, Inc. ("ACTS") v. NYS Department of Health*. The Nassau County court held that the DOH regulations, as well as the Governor's Executive Order, "***are invalid and may not be enforced***."

In a separate case, *Concerned Home Care Providers, Inc. v. NYS DOH*, the Suffolk County Supreme Court in July 2014 reached the opposite conclusion and ***upheld*** EO 38 and the regulations. The court interpreted provisions in the Public Health Law and Social Services as giving "general authority to the DOH to regulate the financial assistance granted by the state in connection with all public health activities, receive and expend funds made available for public health purposes, enter into contracts with entities to provide home health care, and to supervise the administration of [the Medicaid program]." Moreover, the court found that the DOH's regulation of the amount or percentage of State funds or state-authorized payments used to pay for executive compensation and administrative services "…clearly fulfills its statutory mandate to regulate the financial assistance provided by the State in connection with public health care activities."

In November 2015, the trial court in Albany County issued a consolidated decision in a pair of cases challenging EO 38 and the regulations promulgated by DOH (*Coalition of NYS Public Health Plans, et al. v. NYS DOH*, *et al.*, and *LeadingAge New York, Inc., et al. v. Shah, et al).*The Albany court, however, reached yet a third outcome. The court upheld EO 38, and the aspect of the regulation establishing the "hard cap," "limiting use of [SF/SAPs] for administrative expenses and executive

compensation." In issuing her decision, however, Judge Hartman invalidated that part of the regulation that established the "soft cap" and prevented Covered Providers from paying Covered Executives in excess of $199,000, even if the funds used were not SF/SAPs. The court noted that EO 38 did not include anything regarding the soft cap, and the agency establishing such a limitation "flags concerns that the agency was improperly engaged in acting on its own ideas of good public policy," rather than "focusing taxpayer funds on direct care and services." Moreover, the question of whether a corporation's executive's salary should be limited or otherwise subject to oversight, is an issue reserved to the Legislature – and in fact an issue on which the Legislature has already taken action. As such, establishing such a limitation was "not a proper exercise of [DOH's] . . . powers and intrudes on the legislative prerogative to make policy choices about overall executive compensation from sources beyond taxpayer funds."

What Happens Next?

All three of the State Courts that have opined on the validity of EO 38 have done so in the context of the DOH regulations. We are unaware of any challenge to the validity of the 12 other agencies' regulations. Regardless, now that there is a significant split between three courts, it is likely that either the State or the petitioners in the Albany case will appeal. It is clear that, at least for now, the State intends to enforce all of the agencies' regulations, just as it did following the Nassau County decision in April 2014. After that decision, the State merely added a "Legal Notice" to the EO 38 website advising Covered Providers that the regulations were still applicable, other than to those Covered Providers who conduct business within Nassau County. It would seem that until a higher court – likely the Court of Appeals – resolves the conflict now created among the three counties that have heard the EO 38 issue, the State will continue to enforce all of the regulations. The final outcome, however, is yet to be seen.

Greenberg Traurig continues to actively monitor all of the EO 38 developments. 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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