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NYS Appellate Court Upholds Executive Compensation Order and Regulations: What Happens Next?

On Dec. 30, 2015, the New York State Appellate Division, Second Department upheld the validity of Governor Cuomo's Executive Order pertaining to executive compensation and administrative expenses of certain service providers (EO 38), as well as the implementing regulations. This was the first appellate court to rule on this issue. As was explained in prior *GT Alerts*, during 2014 and 2015, three New York State trial level courts (Nassau, Suffolk, and Albany) issued decisions regarding the validity of the Governor's order and the New York State Department of Health (DOH) regulations. The Nassau County Supreme Court *invalidated* EO 38 and the implementing regulations; the Suffolk County court *upheld* EO 38 and the regulations in their entirety; and the Albany Supreme Court took a middle approach – upholding EO 38 and most of the implementing regulations, but striking 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 State appealed the Nassau decision, while the plaintiffs in Suffolk County appealed that trial court's decision, to the Second Department. On Dec. 30, 2015, the Second Department overturned the Nassau County decision and upheld the Suffolk County court's determination, ruling that the administrative expense and executive compensation restrictions are constitutional. Contemporaneously, all of the parties in the Albany County case filed appeals to the Third Department Appellate Division. This *Alert* provides an update on the status of EO 38 regulations and examines how the on-going litigation affects entities otherwise subject to the regulation.

Summary of EO 38 and Implementing Regulations

The EO 38 regulations – promulgated in May 2013, by 13 State agencies – were drafted to limit the amount that Covered Providers, as well as certain subcontractors and agents of Covered Providers could pay to executives, and the amount of administrative expenses that these Covered Providers could 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, and is at least 30% of its total annual New York revenues, is a Covered Provider. DOH regulations further limit the definition of Covered Provider to 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 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 establish an administrative expense cap – now requiring that at least 85% 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."

EO 38 and Regulations Challenged; 3 Courts - 3 Outcomes

Several organizations filed lawsuits in three different counties challenging the validity of the regulations and the underlying Executive Order. In April 2014, the Nassau County trial court in *Agencies for Children's Therapy Services, Inc. (ACTS) v. NYS Department of Health*, held that the DOH regulations, as well as the Governor's Executive Order, "are invalid and may not be enforced." Shortly thereafter, the Suffolk County Supreme Court in *Concerned Home Care Providers, Inc. v. NYS DOH*, reached the opposite conclusion and upheld EO 38 and the regulations. More recently, in November 2015, in the consolidated case *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 County Supreme Court reached a more nuanced conclusion, upholding EO 38 and the regulations generally, but striking 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 noted that not only did DOH lack any statutory authority to restrict Covered Providers from using non-state funds to pay Covered Executives over the $199,000 cap, EO 38 did not include anything regarding the soft cap. DOH imposing 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," and that 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 – one 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."

Second Department Upheld EO 38 and DOH Implementing Regulations

In spring of 2015, the New York State Appellate Division, Second Department heard oral argument for both an appeal brought by the State in the Nassau County *ACTS* case, and by the plaintiffs in the Suffolk County *Concerned Home Care Providers* case. On December 30, 2015, the Second Department reversed the Nassau County court's determination and upheld the Suffolk County court's finding, without acknowledging the Albany Court's findings. In reaching its conclusion, much like the lower courts, the Second Department looked to the test established in the seminal New York Court of Appeals case, *Boreali v. Axelrod*, which set forth four factors to be used in determining whether a regulatory action is within the authority of an executive branch agency. The *ACTS* court explained that "[t]he 'central theme' of a *Boreali* analysis is that 'an administrative agency exceeds its authority when it makes difficult choices between public policy ends, rather than find[ing] means to an end chosen by the Legislature."

Here, the Second Department found that DOH complied with all of the Boreali factors. First, the court said, the Public Health Law and State Finance Law afford DOH broad discretion in the area of "regulat[ing] the financial assistance granted by the state in connection with all public health activities," and "reciev[ing] and expend[ing] funds made available for public health purposes pursuant to law." Moreover, DOH is statutorily authorized to enter into contracts, and when entering into "contracts with private entities to provide public health services, it is statutorily required to 'make a

determination of responsibility of the proposed contractor.'" Reading these statutes together, the court found that even though the Legislature did not "expressly authorize the creation of administrative cost and executive compensation limits," DOH's regulations were "not inconsistent with the . . . statutory provisions or their underlying purpose of obtaining high-quality services with limited available funds." Additionally, the Second Department determined that the Public Health Law and the State Finance Law "charge DOH with making decisions as to the providers it will engage to provide public health services . . . and on what terms." As such, DOH could not be considered to be making decisions from "a clean slate" "without legislative guidance." Finally, the Second Department looked at the legislative history, and determined that even though there were bills introduced in the past that dealt with similar issues, "DOH did not improperly intrude upon a subject of prolonged legislative deadlock"; and finally, DOH did use "special expertise" in crafting the executive compensation and administrative cap regulations. Thus, the Second Department "conclude[d] that the Governor and the DOH acted within their authority in promulgating" EO 38 and the related regulations.

Impact on Entities Subject to the Regulation

Although the Second Department has ruled that EO 38 and the implementing regulations are valid, there remain many open issues. Most critical is what aspects of the regulations are currently enforceable. As of January 2016:

- Administrative Expenses Cap
  - Enforceable against all entities. There is no outstanding court decision striking this limitation down.

- Executive Compensation – Hard Cap
  - Enforceable as to all entities. As is the case with the administrative expense cap, there is no outstanding court decision striking this down.

- Executive Compensation – Soft Cap
  - Not enforceable against the parties to the Albany County case;
  - As to all other entities subject to the regulations, agencies may opt not to enforce, and arguably the soft cap is unenforceable by DOH.

Covered Providers' compliance obligations will also depend on any guidance issued by the State. To date, the State has not updated the EO 38 website or the "Legal Notice" included on that page.

Notably, the cases continue to move through the legal system. The petitioners in the Second Department cases are likely to file motions for leave to appeal. There is, however, a question as to whether the Court of Appeals will grant leave for the Second Department cases. Even if the Court of Appeals does not accept the case, litigation continues as the appeal of the Albany County case has yet to be heard by the Third Department, and regardless of what happens there, it is likely that one of the parties would again appeal the decision to the Court of Appeals. Thus, given the conflicting opinions, the State could opt not to enforce the regulations until there is a definitive resolution of the litigation.

Greenberg Traurig actively monitors 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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