

Health Law

Expert Analysis

Courts Split on Executive Order 38 Limiting Executive Compensation

In his Executive Order 38, Governor Andrew Cuomo directed 13 state agencies, including the Department of Health (DOH), to issue regulations restricting the amounts of executive compensation and administrative expenses of health care and other service providers that receive state funding. The Health Department (and the other agencies) issued regulations that were to take effect on July 1, 2013. Three separate courts have now ruled on challenges to these regulations, with two upholding all or most of the regulations, and one striking them down.

Background

Following extensive press reports about excessive compensation and benefit packages for executives of a large not-for-profit agency that served the developmentally disabled and that depended heavily upon state Medicaid funding, in 2011 Governor Cuomo appointed a task force to investigate executive compensation at not-for-profit organizations that receive support from Medicaid or other taxpayer funding. The task force collected detailed information from thousands of not-for-profit

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organizations in New York that provide health and social services and receive Medicaid reimbursement or other state funding.

Before the task force issued a report, the governor included in his budget to the Legislature a bill to impose caps on

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executive compensation and administrative costs. Before the Legislature acted (it ultimately did not include this provision in the budget), on Jan. 18, 2012, the governor issued Executive Order No. 38 (EO 38) directing the Department of Health and other state agencies to promulgate regulations prohibiting not-for-profit and for-profit entities from using state funds

for executive compensation exceeding \$199,000 per year, and restricting the use of state funds for administrative costs. EO 38 is applicable to organizations deemed "Covered Providers"—entities that receive more than \$500,000 in state funding where that funding accounts for at least 30 percent of the organization's revenue per year, in exchange for "Program Services" to be provided to the public.

In implementing the Health Department regulations, however, the department limited the application of the EO 38 restrictions to certain entities, including hospitals, nursing homes, home health agencies, residential health care facilities, long-term and AIDS care programs, hospices, assisted living residences, emergency service entities, and health maintenance organizations and other entities authorized pursuant to Article 44 of the Public Health Law.

In May 2013, the Health Department adopted final regulations¹ implementing EO 38's executive compensation and administrative cost limits on for-profit and not-for-profit service providers that receive state funding. Besides a prohibition on spending more than \$199,000 on executive compensation (the so-called "hard-cap" restriction), the regulations required that at least 75 percent of the

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operating expenses that are paid for with state funds or payments be spent on program services to recipients, as opposed to administrative expenses, with the cap increasing to 85 percent by 2015.

Administrative expenses include salaries for chief executive directors, financial officers, compensated directors or trustees, managing partners, officers and “key employees.”² Administrative expenses also include costs for accounting, public relations, information technology, human resources, insurance, telephone and computer systems, licenses and permits, office supplies, and subscriptions and conferences.

The regulations also imposed restrictions on executive compensation from all sources, including non-taxpayer-funded revenue, except under certain conditions. These so-called “soft-cap” restrictions permit compensation of more than \$199,000 to covered executives from both state funds and other non-state sources of funding (i) if the compensation is not greater than the 75th percentile of compensation provided to comparable executives in other providers of the same size and within the same service area and the same or comparable geographic area based upon a compensation survey recognized by New York’s Division of the Budget; and (ii) if the compensation was reviewed and approved by the governing body—including at least two independent directors or voting members—and such review includes an assessment of appropriate comparability data.

The DOH 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 the Department of Health and the Division of the Budget.

Multiple lawsuits challenging the regulations ensued. The common thread among the lawsuits is the argument that the Health Department exceeded its authority in issuing the regulations, thereby violating the separation of powers doctrine.

Boreali Factors

The Court of Appeals, in its landmark ruling in *Boreali v. Axelrod*,³ struck down comprehensive anti-smoking regulations promulgated by the New York State Public Health Council after the Legislature failed to act on anti-smoking legislation. In *Boreali*, the court set forth four factors to be used in determining whether a regulatory action is within the authority of an executive branch agency. A 2014 Appellate Division decision⁴ summarized the four factors:

When determining whether an administrative agency has violated the constitutional principle of separation of powers, the Court must consider the ‘coalescing circumstances’ set forth in *Boreali v. Axelrod*, namely, (1) whether the respondents improperly engaged in the balancing of their stated goal and competing social concerns and acted solely on their own ideas of sound public policy; (2) whether the respondents engaged in the interstitial rulemaking typical of administrative agencies or instead wrote on a clean slate, creating their own comprehensive set of rules without benefit of legislative guidance; (3) whether the challenged regulation concerns an area in which the Legislature has repeatedly tried—and failed—to reach agreement in the face of substantial public debate

and vigorous lobbying by a variety of interested factions; and (4) whether the respondents overstepped their bounds because the development of the regulations did not require the exercise of expertise or technical competence by the administrative agency.

One of the challenges to EO 38 was brought by a group of for-profit agencies providing early intervention services for children. In *Agency for Children’s Therapy Services v. New York State Department of Health*,⁵ the Nassau County Supreme Court in April 2014 struck down EO 38 and the DOH regulations. With respect to the first Boreali factor, the court found that the DOH regulations were an attempt by DOH to extract from its statutory authority to enter into contracts and regulate financial assistance a power to direct how much providers pay their executives and how much they expend on administrative services. The court stated that DOH had thereby “‘built a regulatory scheme on its own conclusions about the appropriate balance of trade-offs’ where the agency was not authorized to do so.”

With respect to the second Boreali factor, the court found:

...the DOH did not merely fill in the details of broad legislation, but rather, wrote on a clean slate, created its own comprehensive rules without benefit of legislative guidance.

As to the third Boreali factor, the court found that the Health Department’s regulations were issued and promulgated after the Legislature had rejected the governor’s budget bill containing an identical proposal to cap executive compensation and administrative expenses through provisions that were virtually identical to the terms of EO 38.

Lastly, the court, applying the fourth

Boreali factor, found that there was no evidence that DOH used any special expertise in the field of health in creating the regulations:

...the use-of-funds/anti-excess regulation was a prophylactic approach to costs without the benefit of any evidence of expertise or technical competence. The DOH's rationale that compensation and expense caps will "ensure that taxpayers' dollars are used properly, efficiently, and effectively to improve the lives of New Yorkers" is unsubstantiated. The DOH does not refer to any evidence of taxpayers' dollars being used more efficiently for executive compensation or administrative expense.

Accordingly, the court found that the Health Department had usurped the role of the Legislature in making public policy assessments, and had no authority to determine how much a for-profit entity may pay its executives and spend on administrative expenses.

In a second challenge, *Concerned Home Care Providers v. NYS Department of Health*,⁶ the Suffolk County Supreme Court in July 2014 reached the opposite conclusion and upheld EO 38 and the DOH regulations. The court interpreted provisions in the Public Health Law and Social Services Law 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]...

The court found that the Health Department's regulation of the amount or per-

centage 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." The court concluded:

...the regulations at issue in this case only limit the amount of State funds or State-authorized payments that can be used for executive compensation and administrative expenses. They do not in any way restrict or limit the use

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of other funds or payments for executive compensation or administrative expenses. Thus, the regulations do not truly cap executive compensation or administrative expenses of entities that receive State funds or State-authorized payments. They only limit the amount of State funds or State-authorized payments that entities can use for such purposes.

Two other cases challenging EO 38 and the regulations were brought in Albany County Supreme Court: one by trade associations that collectively represent more than 1,000 not-for-profit and for-profit entities providing care in long-term and skilled nursing facilities, senior housing facilities and adult care and assisted

living communities;⁷ the other by trade associations that represent for-profit and not-for-profit health care and managed care plans.⁸ The challengers claimed that the Health Department had no authority to promulgate regulations limiting executive compensation and administrative costs; that the regulations violated the separation of powers principles enunciated by the Court of Appeals in the Boreali case, and that the caps on executive compensation, the definition of covered providers, and various provisions covering the waivers were arbitrary and unreasonable.

The provider trade associations also claimed that the regulations restricting executive compensation violated the business judgment rule and various laws governing not-for-profit and for-profit corporations. The cases were consolidated and the court issued its decision on Nov. 13, 2015, upholding the hard-cap provisions but voiding the soft cap.

The court first rejected the challengers' claim that the hard-cap regulations violated the separation of powers doctrine. With respect to the first Boreali factor, it found that the Health Department's statutory responsibilities include an obligation to ensure the efficient use of taxpayer dollars in funding and contracting for the delivery of health care and other services:

All aspects of the limitations on expenses to be reimbursed by state funding or state-authorized funding are well-grounded in the respondents' stated purpose—to spend a greater portion of government funding on direct care and services—a goal that is entirely consistent with its statutory goals to administer these funding programs efficiently for the promotion of the public health.

Applying the second *Boreali* factor, the court found that the compensation and administrative expense limits were within the Health Department's statutory mandate:

The Legislature has given the Department of Health broad authority to regulate the financial assistance that the State provides for public health programs; to receive and expend monies made available for public health programs; to enter into contracts with entities to provide health care and services; and, perhaps most importantly here, to administer the medical assistance programs required by federal statute.

With respect to the third *Boreali* factor, the court found that in issuing the regulations limiting compensation and administrative expenses, the Health Department did not improperly intrude upon the prerogatives of the Legislature. The court explained that regulating the use of taxpayer-provided funds by health care providers fell within the executive branch's authority to determine the methods of enforcing legislative policy, and that these limits could be easily distinguished from the "pervasive smoking regulations" that were voided by the Court of Appeals in *Boreali*.

The court then turned to the fourth *Boreali* factor, viz. whether the compensation and expense limits required the exercise of expertise or technical competence. The court found that the Health Department "has extensive experience in approving contracts and setting the parameters of reimbursement for providers of health care and services" and applied that expertise in developing the hard-cap regulations. The court concluded that the compensation and expense limi-

tations did not violate the separation of powers doctrine, and were not arbitrary or capricious.

The court next applied the *Boreali* factors to the soft-cap regulations that limited executive compensation paid from all sources except in certain cases, and reached a different conclusion. It noted that the soft-cap regulations were not part of EO 38, that various statutes enacted by the Legislature addressed the authority of for-profit and not-for-profit corporations to set executive compensation, and that this regulation "appears to be in tension with the legislative choices reflected in these statutes...". The court also found that this part of the regulations failed the fourth *Boreali* factor:

The Department of Health has no special expertise or competence in administering regulations governing the overall compensation of corporate executives, nor has it special expertise or competence in regulating the procedural aspects of corporate governance. The "soft-cap" regulation meddles significantly in the decision-making processes of corporations' governing bodies, both substantively by setting the "75 percent" rule, and procedurally by defining the approval processes themselves.

Analysis

So, we have the Nassau court striking the regulations in their entirety (currently on appeal), the Suffolk court upholding them in their entirety, and the Albany court upholding the hard cap and invalidating the soft-cap provisions. Like the smoking regulations at issue in *Boreali*, the issue of the legality of these controversial regulations is likely headed to the Court of Appeals.

The question of whether the executive branch and its agencies can use payment of taxpayer funds such as Medicaid to control the corporate business practices of the recipients of those funds is an important one for the thousands of health care and other service providers who rely on such funds for a significant portion of their revenue. The resolution of this question could also be another landmark in separation of powers jurisprudence.



1. 10 NYCRR Part 1002.
2. "Key employees" are defined as the top 10 highest paid individuals of the organization, but exclude chairs, directors and other clinical and program personnel in hospitals or other facilities that provide Medicaid services.
3. 71 NY2d 1 (1987). For an analysis of the *Boreali* decision, see Serbaroli, "'Boreali v. Axelrod': The Limits of Agency Power," *New York Law Journal*, Jan. 23, 2013, p.2.
4. *Matter of New York City C.L.A.S.H., Inc. v. New York State Office of Parks, Recreation and Historic Preservation*, 125 AD3d 105, 108 (3d Dept. 2014), lv.den. 25 NY3d 963 (2015).
5. Index No. 15763/12 (Supreme Court Nassau County).
6. Index No. 15593/2013 (Supreme Court, Suffolk County).
7. *Leading Age New York v. Shah*, Index No. 5333-15 (Sup. Ct., Albany County).
8. *Coalition of New York State Public Health Plans v. New York State Department of Health*, Index No. 5352-13 (Albany Co. Sup. Ct.).