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Court of Appeals Upholds Challenge to Executive Order 38 Limiting Executive Compensation

In his Health Law column, Francis J. Serbaroli of Greenberg Traurig discusses the recent decision by New York's Court of Appeals voiding certain regulations issued by the Department of Health pursuant to Governor Andrew Cuomo's Executive Order 38. The court determined that the regulations, which limited the amount of compensation that could be paid to executives of health care providers and managed care plans with significant Medicaid revenues, were the province of the Legislature and not the Department of Health.

By Francis J. Serbaroli | November 26, 2018 | New York Law Journal

It has been three years since our last column discussing court challenges to regulations promulgated pursuant to Executive Order 38 restricting administrative overhead and executive compensation on certain service providers doing business with New York state. Serbaroli, "Courts Split on Executive Order 38 Limiting Executive Compensation," N.Y.L.J., Nov. 25, 2015, p.3. A sharply divided Court of Appeals recently issued a decision resolving these challenges.

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, Gov. Andrew Cuomo appointed a task force in 2011 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 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 executive compensation and administrative costs. Before the Legislature acted (it ultimately did not include this provision in the Budget), the Governor issued Executive Order No. 38 (EO 38) on Jan. 18, 2012, directing the Department of Health (DOH) and 12 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," which are defined as 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 its regulations, however, the DOH limited the application of the EO 38 restrictions to certain entities, including providers such as hospitals, nursing homes, home health agencies, residential health care facilities, long-term and AIDS care programs, hospices, assisted living residences, emergency service entities; and payors such as health maintenance organizations and other entities authorized pursuant to Article 44 of the Public Health Law.

In May 2013, the DOH adopted final regulations (10 NYCRR Part 1002) 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 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 in 2015. Administrative expenses include salaries for chief executive officers, executive directors, financial officers, compensated directors or trustees, managing partners, officers and "key employees", who 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. 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 (1) 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 (2) 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 DOH and the Division of the Budget.

Lawsuits were commenced by coalitions of health care providers and payors challenging both the hard cap and soft cap regulations. Both coalitions represented entities that contract with DOH to provide health care services and are paid significant amounts of money from New York's Medicaid program. The coalitions claimed, among other things, that the DOH, in issuing the regulations, exceeded its regulatory authority and violated the separation of powers doctrine, and further asserted that the regulations were arbitrary and capricious.

After the lawsuits were consolidated, the Albany County Supreme Court partially granted relief, finding that the soft cap regulations were invalid, but also finding that the hard cap regulations did not violate the separation of powers doctrine and were not arbitrary and capricious. *Matter of Leading Age New York, Inc. et al. v. Nirav Shah et al.*, 56 Misc.3d 594, 2015. The Appellate Division affirmed, largely agreeing with the Supreme Court's reasoning, with one Justice dissenting in part. 153 A.D.3d 10 (3d Dept. 2017).

Decision

The Court of Appeals affirmed the Appellate Division in a 4-3 decision issued on Oct. 18, 2018. As had the lower courts, Chief Judge Janet DiFiore relied upon the Court of Appeals' decision in *Boreali v. Axelrod*, 71 N.Y.2d 1 (1987) which set forth four criteria for judging what is justifiable administrative rule-making versus what is policy making that is reserved to the Legislature. She then quoted the court's own summary of the *Boreali* criteria in another case, *Matter of NYC C.L.A.S.H.*, 27 N.Y.3d 174 (2016):

…whether (1) the agency did more than balanc[e] costs and benefits according to preexisting guidelines, but instead made value judgments entail[ing] difficult and complex choices between broad policy goals to resolve social problems; (2) the agency merely filled in details of a broad policy or if it wrote on a clean slate, creating its own comprehensive set of rules without benefit of legislative guidance; (3) the legislature has unsuccessfully tried to reach agreement on the issue, which would indicate that the matter is a policy consideration for the elected body to resolve; and (4) the agency used special expertise or competence in the field to develop and challenged regulation[].

She found that, with regard to the first *Boreali* criterion, the DOH's promulgation of the hard cap regulations was within DOH's statutory authority "to regulate how state funds are expended in furtherance of the goals of maximizing efficiency and quality in the provision of healthcare services." In applying the second *Boreali* criterion, she found that the DOH did not "write on a clean slate," and that the hard cap regulations complied with DOH's mandate to use health care funds in the most efficient and effective manner as possible. Applying the third *Boreali* criterion, she found that the hard cap regulations did not address a topic that was exclusively within the Legislature's purview. Applying the fourth *Boreali* criterion, the Chief Judge found that, in promulgating the hard cap regulations, DOH utilized its own special expertise and:

…drew upon its understanding of the realities of the healthcare industry to adopt detailed definitional, waiver, and exemption provisions tailored to that sector.

Lastly, she found that the hard cap regulations were not arbitrary and capricious, and that the Task Force's discovery of excessive executive compensation within the health care industry, together with the sharp rise in New York's per capita Medicaid spending, provided a rational basis for the hard caps.

Soft Cap

Turning to the soft cap regulations, Chief Judge DiFiore found that, unlike the hard cap which regulated only how providers spend their public funding, the soft cap improperly imposed an overall cap on executive compensation, regardless of the funding source:

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 policy concerns. Put another way, the soft cap imposes a restriction on management of the healthcare industry that is not sufficiently tethered to the enabling legislation identified by DOH, which largely concerns the expenditure of state funding for public healthcare.

As such, Chief Judge DiFiore found that the soft cap embodied a "value judgment" or "public policy" and failed the first *Boreali* criterion. Accordingly, the court affirmed the Appellate Division's voiding of those regulations.

Judge Michael Garcia dissented in part, arguing that the DOH exceeded its authority in promulgating both the soft and hard caps on executive compensation, and that the hard cap was arbitrary and capricious. He agreed with the majority that the portion of the hard cap regulations requiring a limitation on overall administrative expenses was constitutional.

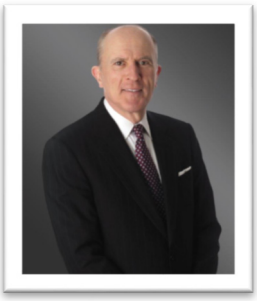
Judge Rowan Wilson also dissented in part but would have upheld both the soft cap and hard cap regulations. He argued that a *Boreali* analysis should not have been applied in this case, and forcefully attacked the *Boreali* decision itself and its subsequent jurisprudence.

Analysis

The Court of Appeals' decision means that, for example, a hospital is now free to pay a covered executive more than $199,000 as long as the hospital receives revenue from sources other than Medicaid or other state funds, (e.g., the hospital also gets revenues from Medicare, private insurance, etc.). Therefore, a hospital could decide that it no longer needs to go through the exercise of trying to fall within either one of the two exceptions to the soft cap. On the other hand, a covered provider that relies exclusively on state funds for its revenues will be limited either to paying its covered executives no more than $199,000 per year, or to seek a waiver from DOH to be permitted to pay more than $199,000.

About the Author:

Francis J. Serbaroli *is a shareholder in Greenberg Traurig and the former vice chair of The New York State Public Health Council. Greenberg Traurig represented one of the parties challenging Executive Order 38.*



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