New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 260—NO. 83
MONDAY, OCTOBER 29, 2018

Outside Counsel

Executive Compensation in the Health Industry: The Court of Appeals Speaks

Health industry organizations that receive state funds have been grappling in recent years with efforts by New York Governor Andrew Cuomo, and by the Department of Health (DOH), to limit the amount of compensation paid to their executives.

Following the issuance of a 2012 Executive Order by the Governor, the enactment of regulations by DOH limiting the compensation permitted to be paid to health industry executives, several actions were filed challenging the regulations. Two of those cases were consolidated at the Supreme Court level—*In the Matter of LeadingAge New York, Inc. v. Shah* and *In the Matter of Coalition of New York State Public Health Plans v. New York State Department of Health* (collectively, *LeadingAge*). *LeadingAge* reached the Court of Appeals, which on Oct. 18, 2018 struck down a critical prohibition contained in the regulations.

This article analyzes how the New York legal landscape has evolved with respect to compensation paid to health industry executives, and the state of the law in light of the Court of Appeals' ruling in *LeadingAge*.

By **Andrew B. Roth**

Executive Order 38 and the Regulatory Background

Amid reports of exorbitant levels of executive compensation paid by not-for-profit organizations, Governor Cuomo issued Executive Order 38 in January 2012 (9 NYCRR 8.38), directing state agencies (including DOH) to promulgate regulations that would limit compensation paid to executives of organizations that receive state funds, such as Medicaid. Although a variety of executive compensation-related abuses by not-for-profit entities served as the impetus for Executive Order 38, it was not limited to not-for-profits—its opening WHEREAS clause refers to both "tax-exempt organizations and for-profit entities …"

> Almost immediately after the DOH Regulations were promulgated, they were challenged in lawsuits filed in Nassau, Suffolk and Albany Counties.

DOH enacted regulations (the DOH Regulations—10 NYCRR Part 1002) that became effective on July 1, 2013, and apply to "covered providers" and "covered executives." A "covered provider" is an entity such as a hospital, nursing home, home health agency, ambulance service, HMO or managed care organization, among others (see 10 NYCRR 1002.1(d)(1-3)), that receives at least $500,000 annually, and at least 30 percent of its revenues, from state funds or state-authorized payments, such as Medicaid, over a two-year period. Like Executive Order 38, the DOH Regulations are not limited to not-for-profits, since many of the entities throughout New York that qualify as covered providers under 10 NYCRR 1002.1(d)(3) include both for-profit and not-for-profit organizations. A "covered executive" is a compensated director, trustee, managing partner or officer of a covered provider (10 NYCRR 1002.1(b)).

The DOH Regulations state that a covered provider cannot use more than $199,000 *of state funds or state-authorized payments* as annual compensation for a covered executive, unless DOH has issued a waiver to the covered

ANDREW B. ROTH *is a partner at Norton Rose Fulbright US, where he focuses on health industry transactional and regulatory matters. He practices in the firm's New York office.*

provider (10 NYCRR 1002.3(a)). This prohibition is known as the "hard cap." The DOH Regulations also prohibited payment of executive compensation in excess of $199,000, *from any source of funding* (including non-state funds), unless (1) the compensation does not exceed the 75th percentile for similarly situated executives in comparable organizations, based on a "recognized" compensation survey, and (2) the compensation has been approved by the covered provider's board of directors (or equivalent governing body), including at least two independent directors or members. This prohibition is known as the "soft cap."

The Legal Challenges

Almost immediately after the DOH Regulations were promulgated, they were challenged in lawsuits filed in Nassau, Suffolk and Albany Counties. The various plaintiffs alleged that the DOH Regulations were overbroad and amounted to impermissible policymaking, in violation of the separation of powers doctrine (these cases were discussed in an earlier column by this author, "Not-for-Profit Executive Compensation: Significant Health Industry Changes," NYLJ, Jan. 25, 2016).

In the Albany case, *LeadingAge*, the hard cap provisions of the DOH Regulations were upheld at the Supreme Court and Appellate Division levels, as not violating separation of powers, and constituting a rational effort by DOH to give effect to its statutory obligation to ensure the effective use of scarce taxpayer dollars, and in particular by application of the hard cap only to the use of the state funds actually received by covered providers.

Not so for the soft cap. The Supreme Court held that DOH exceeded its authority and violated the separation of powers doctrine because it "reaches beyond state funds and state-authorized funds expended for executive compensation," resulting in DOH having "improperly engaged in acting on its own ideas of good public policy" (56 Misc.3d 594, 605-06 [Sup. Ct. Albany County 2015]). The Appellate Division agreed, stating that DOH exceeded its authority by "attempting to regulate compensation from all sources" (153 A.D.3d 10, 25 [3d Dep't 2017]).

The Court of Appeals Speaks

The Court of Appeals began its analysis by noting that the separation of powers doctrine bars administrative agencies from engaging in what essentially is legislative activity, in excess of the agency's regulatory powers. The court examined its seminal ruling in *Boreali v. Axelrod*, 71 N.Y. 1 (1987), which set forth a four-prong test to determine whether an agency has carried out legislative directives as prescribed by statute, or otherwise has encroached into legislative policy-making itself. The Court of Appeals summarized the *Boreali* factors (Opinion, p. 11, quoting *Matter of NYC C.L.A.S.H. v. New York State Office of Parks, Recreation & Historic Preservation*, 27 N.Y.3d 174, 179-80 [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 the challenged regulation."

The court looked first at the hard cap and upheld that portion of the DOH Regulations (Opinion, pp. 13-14):

> "Here, with respect to the hard cap regulations—which regulate only the manner in which state health care funding is expended—we conclude that DOH did not exceed its authority. Applying the first *Boreali* factor, promulgation of the hard caps reflects a 'balanc[ing] [of] costs and benefits according to pre-existing guidelines' set by the Legislature—not a new 'value judgment' directed at resolution of a 'social problem.' The enabling statutes reflect the Legislature's policy directive that DOH oversee the efficient expenditure of state health care funds to ensure high-quality services and provide guidance to DOH in implementing regulations consistent with that directive. The hard cap regulations are thus 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. DOH rationally concluded that requiring that a high proportion of state funding will be used directly for medical services will further the legislative goal of maximizing state resources for the purchase of high-quality care." (internal citations and footnotes removed).

The Court of Appeals found that as to the hard cap, DOH adhered to the remaining *Boreali* factors since (1) it did not "'write on a clean slate' but acted pursuant to a preexisting directive;" (2) the legislature did not attempt but fail to reach agreement on this issue, notwithstanding there having been prior proposals relating to executive compensation; and (3) DOH did, in fact, use special expertise in crafting the hard cap regulatory provisions. Opinion, pp. 17-19.

Turning to the soft cap aspect of the DOH Regulations, the Court of Appeals affirmed the lower court and

So, for tax-exempt health industry organizations, the "soft cap" label from the DOH Regulations may no longer be in effect, but essentially the same reasonableness and comparability examinations of executive compensation must continue to take place.

Appellate Division determinations that DOH exceeded its regulatory mandate in attempting to proscribe executive compensation from other than state funds. Three judges wrote partial dissents, with Judges Wilson and Rivera voting to uphold both the hard and soft compensation caps, and Judge Garcia voting to strike down both compensation caps. According to the majority (Opinion, pp. 21, 24-25):

> "Unlike the hard cap regulations, which regulate only how providers use public funding, the soft cap imposes an overall cap on executive compensation, regardless of the funding source. The soft cap thus pursues a policy consideration—limited executive compensation—that is not clearly connected to the objectives outlined by the Legislature but represents a distinct 'value judgment.' 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. Put another way, the soft cap imposes a restriction on management of the health care industry that is not sufficiently tethered to the enabling legislation identified by DOH, which largely concerns the expenditure of state funding for public healthcare. In this regard, the agency 'wrote on a clean slate' … Rather than determining the best way to regulate toward the legislative goal identified in its enabling legislation (i.e., using state funds to purchase affordable, quality care) 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."

Recommendations

Where do New York health industry organizations (i.e., covered providers) go from here?

The hard cap is here to stay. As a result, covered providers must adhere to the prohibition on payment of executive compensation in excess of $199,000 annually, *from state funds or state-authorized payments*.

A more nuanced approach is necessary with regard to executive compensation, even when paid from other than state funds or state-authorized payments (i.e., the now invalidated soft cap). While the soft cap sections of the DOH Regulations have been struck down, they are similar to the mechanism that has long been required at the federal level to be followed by tax-exempt health industry organizations (which, in New York, include medical schools, virtually all hospitals, many nursing homes, some HMOs/managed care organizations, and other health industry entities) pursuant to the "Intermediate Sanctions Regulations" of the Internal Revenue Code (26 C.F.R §53.4958-6(a)). Under the Intermediate Sanctions Regulations, compensation paid to an executive is entitled to a "rebuttable presumption of reasonableness," and would not constitute an "excess benefit transaction" (resulting in penalties), if the following conditions are met: (1) the compensation is approved in advance by the independent members of the entity's governing body or other authorized body; (2) the authorized body based its determination on comparability data (such as a compensation survey); and (3) there is adequate contemporaneous documentation of the compensation determination. There is no base threshold ($199,000 or otherwise) that serves as a trigger to the applicability of the Intermediate Sanctions Regulations.

So, for tax-exempt health industry organizations, the "soft cap" label from the DOH Regulations may no longer be in effect, but essentially the same reasonableness and comparability examinations of executive compensation must continue to take place.