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Expert Analysis

Not-for-Profit Executive Compensation: Significant Health Industry Changes

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The legal landscape is rapidly evolving in the area of executive compensation paid by New York not-for-profit corporations that receive state funds.

Within the past three months, three court decisions were issued, two from the Appellate Division, Second Department, and one from the Supreme Court, Albany County, addressing New York State Department of Health Regulations (DOH Regulations) which set limits on administrative expenses and executive compensation.[1] They were established under Governor Andrew Cuomo's Executive Order No. 38.[2] This article analyzes those court decisions, and what they mean for the future of executive compensation regulation and reform for New York not-for-profit corporations.

Executive Order, Regulations

In January 2012, Governor Cuomo issued his Executive Order, calling upon New York state agencies to promulgate regulations limiting executive compensation for New York not-for-profit organizations that receive state funds, such as Medicaid. Since then, 13 state agencies, including DOH, enacted regulations implementing the Executive Order.

When we wrote on this topic in an earlier column,[3] the DOH Regulations had recently become effective, on July 1, 2013. The regulations state that a "covered provider" (e.g., a hospital, nursing home, home health agency, or managed care organization that receives state funds), may not use more than $199,000 per year of state funds or state-authorized payments for compensation paid to a "covered executive" (e.g., a director, trustee, managing partner, or officer), unless the covered provider has obtained a waiver from DOH.

A covered provider, however, may pay annual compensation greater than $199,000 from any source of funding, if the compensation: (i) is less than the 75th percentile of compensation provided to comparable executives of similarly situated providers, based on a "recognized" compensation survey[4]; and (ii) has been reviewed and approved by the covered provider's board of directors or other governing body, including at least two independent directors or members.

This so-called "soft cap" provision provides for a process similar to the exercise required to be conducted by tax-exempt organizations under Treasury regulations promulgated pursuant to Section 4958 of the Internal Revenue Code (known as the Intermediate Sanctions Regulations). The Intermediate Sanctions Regulations provide that payments made under a compensation arrangement, including benefits, to an executive are presumed to be "reasonable," and not an "excess benefit transaction" (which carries associated penalties), under the following conditions: (i) the compensation arrangement is approved in advance by the independent members of the tax-exempt entity's governing body or other authorized body; (ii) the authorized body "obtained and relied upon appropriate data as to comparability prior to making its determination"; and (iii) the authorized body adequately documented the basis for the determination concurrently with making that determination.[5]

> Within the past three months, three court decisions addressed Department of Health Regulations which set limits on administrative expenses and executive compensation.

The DOH Regulations also require that at least 85 percent of a covered provider's operating costs must be for "program services expenses rather than administrative expenses," and that covered providers submit an annual disclosure form demonstrating their regulatory compliance.[6]

'Children's Therapy Services'

In *Agencies for Children's Therapy Services v. New York State Department of Health*,[7] decided on Dec. 30, 2015, the Appellate Division, Second Department, reversed a Nassau County Supreme Court decision from 2014[8] that found the Executive Order and the DOH Regulations invalid and unenforceable. The plaintiff had alleged that the DOH Regulations constituted improper policymaking, in violation of the constitutional separation of powers doctrine. The Supreme Court ruled that DOH exceeded its authority in promulgating the DOH Regulations.

The Appellate Division analyzed the leading Court of Appeals authority on point, *Boreali v. Axelrod*,[9] a 1987 ruling that established a detailed, four-prong test to determine whether an administrative agency exceeds its authority by intruding into legislative policy-making, rather than devising rules to implement the policies chosen by the Legislature and embodied in enabling legislation. In *Agencies for Children's Therapy Services*, the Second Department summarized the four Boreali factors as follows:

> (1) whether 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) whether 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) whether the [L]egislature 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) whether the agency used special expertise or competence in the field to develop the challenged regulations.[10]

In applying the first Boreali factor to the DOH Regulations, the Appellate Division found that DOH "did not attempt to resolve a complex issue implicating broad political, social, and economic concerns beyond its purview or to act on its own idea of sound policy." The court stated that the waiver provisions of the DOH Regulations "further the DOH's purpose of ensuring the efficient provision of quality services with the limited funds it has to disburse."[11]

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Analyzing the second Boreali factor, the court determined that DOH did not write on a "clean slate," creating its own set of rules without the benefit of legislative guidance. Under the Public Health Law, the Legislature authorized DOH to regulate state-granted financial assistance for public health activities, receive and disburse funds made available by law for public health purposes, and enter into contracts and agreements as necessary to carry out the general intent and purposes of the Public Health Law, including contracts that provide for state payments for materials, equipment or services.[12]

The Second Department held that, while the Legislature did not expressly authorize the creation of administrative cost and executive compensation limits, DOH's decision to establish such limits in order to guide and control its own spending and contracting decisions represented a valid means to achieve the Legislature's expressed ends.

As to the third Boreali factor, the Appellate Division stated that DOH did not improperly intrude upon a subject of prolonged legislative deadlock. The court found that, while executive compensation and administrative cost legislation was previously introduced but not adopted by the Legislature, the Court of Appeals did not consider this type of legislative history significant in *Boreali*. Thus, the Second Department said that the Legislature's failure to enact similar legislation in prior years does not lead to the conclusion that DOH exceeded its authority in promulgating the DOH Regulations.

With respect to the fourth Boreali factor, the Appellate Division rejected the plaintiff's contention that DOH merely restated the provisions set forth in executive compensation legislation previously proposed by the governor, which ultimately did not pass. The court instead found that DOH developed the DOH Regulations as a result of the agency's special expertise, based on independent research and multiple revisions, taking into account the feedback of stakeholders, such as agencies and organizations that are subject to the DOH Regulations.

Based on its analysis of the four Boreali factors, the Appellate Division reversed the decision of the Nassau County Supreme Court, holding that Governor Cuomo and DOH acted within the scope of their authority in promulgating the executive order and the DOH Regulations.

After the lower court decision was rendered in 2014, the state published "guidance," on a website devoted to the Executive Order,[13] stating that covered providers conducting business in Nassau County need not file executive order disclosures affirming their compliance with the DOH Regulations. However, based upon the new appellate decision, it is likely that the state will update its guidance to require Nassau County covered providers to make Executive Order disclosures.

Home Care Providers Case

At approximately the same time that *Agencies for Children's Therapy* was decided in Nassau County, the Suffolk County Supreme Court considered a similar case, *Concerned Home Care Providers v. New York State Department of Health*,[14] and came to the opposite conclusion. The Suffolk County ruling stated that the Executive Order and the DOH Regulations were not unconstitutional, invalid or violative of the separation of powers doctrine. Also on Dec. 30, 2015, the same Appellate Division panel that reversed the Nassau County Supreme Court decision in *Agencies for Children's Therapy* affirmed *Concerned Home Care Providers* based upon the reasons set forth in the panel's opinion in *Agencies for Children's Therapy Services*.[15]

The Appellate Division remitted both cases—*Agencies for Children's Therapy Services* and *Concerned Home Care Providers*—back to the respective Supreme Court parts for entry of judgments declaring that the Executive Order and the DOH Regulations are valid and enforceable.

'LeadingAge New York'

A third case, *LeadingAge New York v. Shah,*[16] brought in the Supreme Court, Albany County, and also challenging the Executive Order and the DOH Regulations, was decided on Nov. 13, 2015. The Albany Supreme Court upheld the Executive Order, and most, but not all aspects of the DOH Regulations. The Albany Supreme Court struck down the "soft cap" provision—the provision that, as described above, allows a covered provider to pay a covered executive more than $199,000 per year if the specified elements (similar to the Intermediate Sanctions Regulations) are met. The court concluded that "with the exception of the 'soft cap' provision…the [DOH Regulations] do not violate the separation of powers doctrine, nor are they arbitrary and capricious."[17]

> In applying the first Boreali factor to the DOH Regulations, the Appellate Division found that DOH "did not attempt to resolve a complex issue implicating broad political, social, and economic concerns beyond its purview or to act on its own idea of sound policy."

It appears that there are two possible interpretations of the Albany decision: (i) the elimination of the "soft cap" means that $199,000 becomes a hard cap, and there is no mechanism (other than receiving a waiver from DOH) available to exceed that amount; or (ii) perhaps given the economics of recruiting and retaining senior executive healthcare talent, covered providers may be permitted to pay covered executives amounts in excess of $199,000 if such funds are not state funds or state-authorized payments, without having to meet the required elements set forth in the DOH Regulations. However, at the time of this writing, we have found no guidance from the state as to how this decision will be interpreted, or how it will affect enforcement of the DOH Regulations. In addition, the case has been appealed to the Appellate Division, Third Department. We await appellate guidance as to how the striking down of the "soft cap" by the Albany Supreme Court will affect covered providers.

Recommendations

Notwithstanding the striking down of the "soft cap" provisions by the Albany Supreme Court in *LeadingAge New York*, there are now two Appellate Division decisions that have upheld the DOH Regulations in whole, including the "soft cap" provisions. These Appellate Division decisions were handed down subsequent to the Albany Supreme Court case and were therefore not considered by the Albany court. Therefore, compliance with the DOH Regulations, including the "soft cap" provisions, remains important.

Moreover, at the federal level, the Intermediate Sanctions Regulations apply, and have at all times continued to apply, to tax-exempt New York not-for-profit corporations. New York not-for-profit corporations must maintain their policies and practices that enable them to comply with the federal Intermediate Sanctions Regulations, as well as the DOH Regulations, as they currently apply.

Specifically, organizations should continue to (i) ensure that executive compensation levels do not reach the 75th percentile based on appropriate comparability data, (ii) have the compensation levels determined by independent members of the organization's Board of Directors, an authorized committee of the board (i.e., the Executive Committee), or a designee of the Board/Executive Committee (such as the CEO), within the parameters established by the Board/Executive Committee, and (iii) properly document the actions taken. In this way, tax-exempt, not-for-profit corporations will remain in compliance with the DOH Regulations and the Intermediate Sanctions Regulations, even though the future of the DOH Regulations may still be uncertain.

1. 10 NYCRR Part 1002.
2. Executive Order. No. 38: Limits on State-Funded Administrative Costs & Executive Compensation, Jan. 18, 2012.
3. "New York Cracks Down on Executive Compensation for Not-for-Profits," NYLJ, Nov. 22, 2013.
4. See "Executive Order 38 Compensation: Acceptable Compensation Surveys," available at http://executiveorder38.ny.gov/sites/default/files/EO_38_Survey_Options_6-25-14.pdf, for guidelines setting forth the compensation surveys that will be recognized by the Division of the Budget and the 13 state agencies, including DOH.
5. 26 C.F.R. §53.4958-6(a).
6. 10 NYCRR §§1002.2, 1002.5.
7. No. 15763/12, 2015 WL 9486329 (N.Y. App. Div. 2015) (hereafter *Agencies for Children's Therapy Services*).
8. *Agencies for Children's Therapy Services, Inc. v. . N.Y. State Dep't of Health*, No. 15763/12, 2014 WL 1694979 (Sup. Ct., Nassau Co. 2014).
9. 71 NY2d 1 (1987).
10. *Agencies for Children's Therapy Services*, at *4 (quoting *Greater N.Y. Taxi Assn. v. New York City Taxi & Limousine Comm'n.*, 25 NY3d at 610-612) [internal quotation marks omitted].
11. *Agencies for Children's Therapy Services,* at *5.
12. *Agencies for Children's Therapy Services*, at *4; see Public Health Law §§201[1][o],[p], 206[3]. See also State Finance Law §§163[1][c],[j], 4[d], 9[f] (describing the DOH's responsibility to make financially responsible assessments and decisions when contracting with private entities to provide public health services).
13. Executive Order No. 38, http://executiveorder38.ny.gov/ (last visited Jan. 15, 2016).
14. *Concerned Home Care Providers v. New York State Dep't of Health*, 45 Misc.3d 703, 704, 994 N.Y.S.2d 789, 791 (Sup. Ct., Suffolk Co. 2014).
15. *Concerned Home Care Providers, Inc. v. N.Y. State Dep't of Health*, 21 N.Y.S.3d 631 (2d Dept. 2015).
16. No. 5333-13 (Sup. Ct., Albany Co. 2015).
17. Id.