

Court of Appeals Affirms Lower Court's Decision Striking Down "Soft Cap" on Executive Compensation

On October 18, 2018, the New York Court of Appeals, in a 4-3 decision, affirmed an Appellate Division decision striking down the so-called "soft cap" and affirming the "hard cap" limitations on executive compensation under the NYS Department of Health ("DOH") regulations implementing Executive Order # 38 ("EO 38"). Specifically, the Court of Appeals upheld the regulations on covered providers, such as hospitals licensed under Article 28 of the Public Health Law, which imposed limits on administrative expenses and executive compensation to the extent funded by "state funds" – the so-called "hard cap" - (which include funds in the State budget to pay for State funded program services, e.g., Cystic Fibrosis Program, Early Intervention Program) or "state-authorized payments" (which include funds that are distributed or disbursed upon a New York State agency's approval, e.g., Medicaid payments) (collectively, "State Funds"). The Court invalidated the EO 38 regulations which placed limitations – the so-called "soft cap" - on the covered provider's use of non-State Funds, e.g., private funds, funds from commercial payors, etc., for executive compensation.

BACKGROUND

EO 38 issued by Governor Cuomo in January 2012 directed agencies providing State Funding to service providers, to impose limits on the amount of State Funds that can be used for administrative costs and executive compensation. In accordance with EO 38, DOH (and other state agencies) promulgated regulations which prohibited a covered provider from compensating a covered executive in an amount greater than \$199,000 per year using only State Funds unless a waiver was obtained from the applicable state agency. The regulations further prohibited a covered provider from compensating an executive in an amount greater than \$199,000 per year using a combination of State Funds and any other sources of funding, e.g., commercial payor funds and other private funds, unless the executive compensation falls within the 75th percentile of compensation paid to comparable executives in other providers of the same size and within the same program service sector or comparable geographic area; and the compensation was reviewed and approved by the covered provider's board or a board designated committee, including at least two independent directors, whose actions were reviewed and ratified by the board.¹ The regulations further limited the provider's use of State Funds for administrative costs.

The appeal was brought by LeadingAge New York, Inc., an association representing nursing homes, assisted living programs, home care agencies and others; and a coalition of trade associations representing health-care plans, health maintenance organizations and long-term care plans. These entities challenged the regulations as an improper attempt to regulate matters that were beyond the scope of DOH's authority and a violation of the separation of powers doctrine; and upon the basis that the regulations were arbitrary and capricious.

DECISION

With respect to the hard cap limitations on administrative expenses and executive compensation when only State Funds are used, the Court of Appeals determined that DOH did not exceed its authority in promulgating the regulations. It found that the Legislature delegated sufficient authority to DOH to receive, manage and expend State Funds; to oversee the Medicaid program and the funding it provides, all with the goal of ensuring that the limited public funding available be directed toward high-quality services. The Court noted that, by implementing the hard cap regulations, DOH was complying with a Legislative directive to use state healthcare funds in the most efficient and effective manner as possible. The Court also rejected the petitioners' assertion that the hard cap regulations were arbitrary and capricious,

¹ The regulations provide that executive compensation is improper if "either" the compensation is greater than the 75% percentile of comparable executives or the compensation was not reviewed and approved by the Governing Board. The Court's opinion reiterated the option of either of these two requirements, but it did not comment on EO 38 guidance that requires both requirements to be met to ensure compliance. See, EO 38 Provider Guidance, at page 40, available at: <https://executiveorder38.ny.gov/guidance/document>.

noting that a task force created by Governor Cuomo to look at the issue, discovered excessive executive compensation within the health care industry and provided a rational basis for the hard caps.

The Court, however, found that the soft cap regulations differed greatly from the hard cap regulations because the agency attempted to regulate, without the benefit of legislation, the use of non-State Funds, e.g., commercial payor funds and other private funds. The Court found that the attempted regulation of the use of non-State Funds inappropriately pursued policy considerations instead of insuring that State Funds were used to support quality health care. The Court determined that the soft cap was not clearly connected to the objectives outlined by the Legislature but represented a value judgment, i.e., determining how much a covered executive in the health care industry should be paid. The Court rejected DOH's argument that the State Finance Law required it to ensure that services were purchased from responsible vendors, finding that "DOH had not shown a connection between a provider's decision to use private funds to compensate its executive staff handsomely or even excessively and the absence of any of these essential contractor characteristics."

DISSENTING OPINIONS

There were two dissenting opinions. Judge Garcia agreed with the majority that the limitation on administrative expenses was constitutional, but believed DOH exceeded its authority in imposing the hard cap on executive compensation. Judge Wilson objected to the majority's application of the principles in the seminal case of Boreali v. Axelrod, 71 NY2d 1 (1987), in its determination on the constitutionality of the regulations. Judge Wilson agreed with the majority that the limitation on administrative expenses was constitutional, but disagreed with the majority that the soft cap regulation was unconstitutional.

SOME INITIAL OBSERVATIONS

It is interesting that Judge Garcia, in his dissenting opinion, 2018 WL 5046104, at *12, noted that there was nothing in the record to indicate that DOH had ever granted one waiver since the EO 38 regulations were promulgated. There was no discussion of how many waivers had been filed.

Given the Court's decision, presumably, a covered provider can pay a covered executive compensation in excess of the 75th percentile without an approved waiver if non-State Funds are used to pay the incremental compensation above the 75th percentile. In that circumstance, we recommend that the board and/or the designated committee engage in its usual compensation approval process (taking into account EO 38 and IRS principles, if applicable), with the assistance and advice of its attorneys and compensation consultants; state its business reasons for approving compensation above the 75th percentile; identify the specific non-State funds to be used; approve the action; and, of course, memorialize the action in the minutes. It is unknown if DOH will issue guidance on the use of non-State Funds by a covered provider in paying executive compensation.

The EO 38 limits on administrative expenses and the hard cap on executive compensation remain in effect. Covered providers need to submit an EO 38 Disclosure Form for each covered reporting year.

The Court of Appeals decision, Matter of Leading Age New York, Inc. et al v. Shah, 2018 WL 5046104 (N.Y., 2018) is available at the following link: <http://www.nycourts.gov/ctapps/Decisions/2018/Oct18/Oct18.html>

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