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NEW YORK'S HIGHEST COURT STRIKES DOWN DOH'S "SOFT CAP" ON EXECUTIVE COMPENSATION

Authors: Joshua E. Gewolb and Scott R. Simpson

New York's highest court has invalidated a key component of Executive Order 38 ("EO 38"), which limits executive compensation and administrative expenses at State-funded social service providers. Specifically, the New York State Court of Appeals held that while the State can place limits on compensation paid with State funds, it cannot place limits on use of private funding to pay higher salaries.

Background

In January 2012, Governor Andrew Cuomo issued EO 38 on the heels of prominent media reports detailing alleged excessive compensation paid to executives at not-for-profit New York health care providers that received State funds through the Medicaid program. EO 38 instructed State agencies, including the New York State Department of Health ("DOH"), to issue regulations that: (1) limited providers' administrative costs to fifteen percent (15%) (when compared to program service costs) by 2015, and (2) prohibited the use of State funds for executive compensation exceeding \$199,000 annually. In addition to these "hard caps" on the use of State funds, DOH's EO 38 regulations included a "soft cap" on executive compensation. The soft cap only allows executive compensation over the \$199,000 maximum using non-State funds if that compensation: (i) does not exceed the seventy-fifth (75th) percentile of compensation paid to similarly-situated executives, and (ii) is approved by the provider's board, including at least two (2) independent directors.

Several legal challenges have been mounted against EO 38. With few exceptions, New York courts have generally upheld the regulations. Now, the Court of Appeals, in its October 18, 2018 decision in *In re LeadingAge New York, Inc. v. Shah*, likely provides a definitive answer as to the constitutionality of DOH's EO 38 regulations.

The Court's Decision

The Court of Appeals upheld the hard caps on executive compensation and administrative costs but found that the soft cap on executive compensation exceeded DOH's regulatory authority.

The Court's majority opinion hinged on the separation of powers doctrine. The legislature is constitutionally empowered to make laws, while it is the charge of the executive branch (including State agencies like DOH) to adopt and enforce regulations that do not expand upon the scope of the laws passed by the legislature, but instead provide details consistent with the broader language of those laws. If an agency exceeds the scope of the powers granted to it by the legislature, the agency violates the separation of powers doctrine and its actions are unconstitutional.

DOH's legislative mandate to maintain New York's Medicaid program was acknowledged by the Court. Inherent in that mandate is DOH's responsibility to ensure that Medicaid recipients receive high quality health care services at reasonable cost to the State. The majority opinion echoed the trial court judge in explaining that DOH was well within its delegated powers when it sought to ensure that the State received the biggest "bang for its buck" in the expenditure of State funds to health care providers. By limiting the amount of State funds directed at administrative costs and executive compensation through the hard caps, the Court reasoned that providers could channel more State funds towards programmatic purposes. Because the Court found that DOH acted within its statutorily-granted authority, health care providers will have to continue to comply with the hard caps.

The soft cap did not fare as well. The Court did not think that the soft cap shared a close enough nexus to DOH's ability to regulate State health care funding to withstand scrutiny, stating:

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." - Page 21 of the Majority Opinion

The majority also observed that DOH did not show any connection between a provider's decision to pay its executives well and the provider's performance as a State contractor. Further, the majority hinted that it may have decided the case differently had DOH made the programmatic determination that there was a correlation between large executive compensation packages and poor quality of care or bad patient outcomes and promulgated the soft cap as a result. However, without that determination or a direct link to DOH's duty to oversee the appropriate expenditure of New York health care funds, the Court found that DOH was outside its authority when it imposed the soft cap.

Where Does This Leave Us?

Technically, the *LeadingAge* case dealt only with DOH's EO 38 regulations and not the EO 38 regulations promulgated by other State agencies. However, because there is no meaningful distinction between the different State agencies' EO 38 regulations, *LeadingAge* extends beyond DOH's regulations to all EO 38 regulations.

As indicated above, New York health care providers remain subject to DOH's hard caps on executive compensation and administrative expenses. However, it is now possible to make payments utilizing non-State funds over the \$199,000 compensation cap. Even before EO 38, federal tax law and applicable New York State law limited the compensation of executives of not-for-profit, tax-exempt health care providers by requiring that all executive compensation be reasonable. Finally, the Tax Cuts and Jobs Acts of 2017 imposes a twenty-one percent (21%) excise tax on: (1) any remuneration over \$1 million dollars, and (2) "excess parachute payments," that a tax-exempt organization pays to its five (5) highest paid employees.

If you would like to discuss the impact of the *LeadingAge* decision, or executive compensation generally, contact any member of our Not-for-Profit Organizations, Executive Compensation, or Health Care Practice Groups at 585.232.6500, or visit www.hselaw.com.

Joshua E. Gewolb, 585.231.1151, jgewolb@hselaw.com

Scott R. Simpson, 585.231.1153, ssimpson@hselaw.com

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