STATE OF NEW YORK
SUPREME COURT – COUNTY OF ALBANY
Index No. 264-10

NEW YORK INSURANCE ASSOCIATION, INC., AMERICAN TRANSIT INSURANCE COMPANY, EVEREADY INSURANCE COMPANY, GREATER NEW YORK MUTUAL INSURANCE COMPANY, KINGSTONE INSURANCE COMPANY, MERCHANTS MUTUAL INSURANCE COMPANY and UTICA MUTUAL INSURANCE COMPANY,

Plaintiffs,

-against-

STATE OF NEW YORK, ANDREW M. CUOMO, Governor of the State of New York; BENJAMIN M. LAWSKY, Superintendent of the New York State Department of Financial Services; and ROBERT L. MEGNA, as Director of Budget,

Defendants.

THE NEW YORK HEALTH PLAN ASSOCIATION, INC.; AETNA HEALTH INC.; AETNA HEALTH INSURANCE COMPANY OF NEW YORK; CDPHP UNIVERSAL BENEFITS, INC.; CAPITAL DISTRICT PHYSICIANS' HEALTH PLAN, INC.; HEALTH NET OF NEW YORK, INC.; HEALTH NET INSURANCE OF NEW YORK, INC.; HEALTHNOW NEW YORK INC.; INDEPENDENT HEALTH ASSOCIATION, INC.; INDEPENDENT HEALTH BENEFITS CORPORATION; MVP HEALTH PLAN, INC.; MVP HEALTH INSURANCE COMPANY; MVP HEALTH SERVICES CORP.; PREFERRED ASSURANCE COMPANY; OXFORD HEALTH INSURANCE, INC.; OXFORD HEALTH PLANS (NY), INC.; UNITEDHEALTHCARE INSURANCE COMPANY OF NEW YORK; and UNITEDHEALTHCARE OF NEW YORK, INC.

Intervenor-Plaintiffs,

-against-

STATE OF NEW YORK; ANDREW M. CUOMO, in his official capacity as Governor of the State of New York; BENJAMIN M. LAWSKY, in his official capacity as Superintendent of the New York State Department of Financial Services; and ROBERT L. MEGNA, in his official capacity as Budget Director of the State of New York,

Defendants.

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

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PRELIMINARY STATEMENT

This action challenges the legality of amounts required to be paid by Plaintiffs into a Special Revenue Account of the New York State Insurance Department ("SID" or "the Department") for what were masqueraded as proper regulatory assessments pursuant to Section 332 of the New York State Insurance Law ("Section 332"). That section allows the Superintendent of the New York State Department of Financial Services and, prior to fiscal year 2011 – 2012 its predecessor the New York State Insurance Department, (collectively referred to hereafter as "SID" or the "Department") to assess insurers who are domiciled in the State of New York to cover the operating expenses of SID in performing the agency's functions of regulating and licensing insurers, including expenses categorized as direct and indirect costs.

Despite the clear and unambiguous language of Section 332, and the statute's use of commonly understood words of art, Defendants have converted the insurance assessment into a limitless revenue source used to fund general activities of the state through programs known as "suballocations," as well the costs of three subsidy programs.[1] Plaintiffs will refer to all of the challenged programs as the "suballocations" or "suballocated programs." Defendants seek to justify the Section 332 suballocations by converting the well-understood term "indirect costs' into a litigation-created definition that has no basis whatsoever in state budgeting, in case law, or in anything but their creative imaginations. These suballocated programs, which had for the most part previously been funded by the New York State

[1] This is not the first time that the State has used special revenue accounts as slush funds. In *American Assoc. of Bioanalysts v. New York State Dep't of Health*, No. 6225-99, (Sup. Ct. Spec. Term Albany County) ("*AAB II*") the Department of Health had abused assessments charged to clinical laboratories to cover the costs of regulating those laboratories under the clinical laboratory reference system. As here, the Department had inflated the fees charged the regulated laboratories by including millions of dollars of costs that were not necessary and often entirely unrelated to the regulation program. After trial, Justice Sheridan found that the Department had "turned the clinical laboratory reference system special revenue account into an unauthorized and unsupervised revenue stream that is limited only by the bounds of defendant's creativity." (*See* Affirmation of David E. Nardolillo, dated November 22, 2013 ("Nardolillo Aff.") ¶3 Ex. A. ("*AAB II* Decision and Order"), p. 26.)

General Fund or the Health Care Reform Act ("HCRA") taxes on items like cigarettes, are outside the scope of assessable costs under Section 332 and are unauthorized charges under the law. From fiscal year 2008-2009 through fiscal year 2011-2012, the suballocated programs have totaled over $1.2 billion. Meanwhile, Plaintiffs have already been paying, and continue to pay, the proper indirect costs of SID: the costs of Central Service State Agencies which are charged to SID via the Statewide Cost Allocation Plan and identified in the SID's budget as indirect costs.

The use of the Section 332 assessment as a general state funding source, rather than a regulatory assessment, escalated when Defendants implemented laws which allowed the assessment to be set at certain levels so that funds that were purportedly collected for the suballocations could be diverted or "swept" directly into the New York State General Fund in order to address the State's budget deficits. Defendants swept nearly $90,000,000 in unused Section 332 monies into the General Fund.

Defendants have argued that the suballocated programs are proper because, they claim, Section 332 allows them to assess the costs of suballocated programs on domestic insurers if these costs "relate to" the insurance business or SID's "regulatory concerns," such as the reduction in the number and amount of insurance claims. This standard, which was fabricated by Defendants after this litigation commenced, has already been rejected by other courts when applied to other regulatory assessments, is contrary to legislative history, deliberately ignores Defendants' own budget guidelines and accepted definitions of direct and indirect costs, and is so broad as to potentially cover any activity undertaken by the New York State government under its police powers. Defendants' specious justification must be rejected here.

Plaintiffs challenge the assessments and general fund sweeps on several grounds. First, the amounts collected under Section 332 are outside the scope of chargeable costs under that section. Second, to the extent that the Court determines that the suballocations are within the scope of Section 332, Plaintiffs challenge the assessments on the ground that they constitute illegal taxes and not proper

regulatory fees. While New York State agencies may assess regulatory fees, those fees must be necessary to the agency's regulatory program and correlate to the expenses of that regulatory program or to the benefits or services accessed by the payment of those assessments. *See, e.g., Walton v. New York State Dep't of Correctional Services*, 13 N.Y.3d 475, 485 (2009). If a purported regulatory fee or assessment does not meet that standard, it will be deemed a tax. For example, if funds collected via the Section 332 assessment are used to support other state objectives, rather than just the regulation of the affected industry, then the charges are deemed to be taxes. *See, e.g., Nitkin v. Administrator of Health Services Admin.*, 91 Misc.2d 478, 479 (Sup. Ct., N.Y. County 1975), *aff'd*, 55 A.D.2d 566 (2d Dep't 1976), *aff'd*, 43 N.Y.2d 673 (1977). It is undisputed in this case that Section 332 assessment funds were used for general state purposes, either via the suballocated programs, or by simply taking funds that went unspent by the suballocated programs and sweeping them directly into the New York State General Fund for Defendants' discretionary use.

Plaintiffs also challenge the legality of these de-facto taxes on several constitutional grounds. The assessments and sweeps violate the constitutionally-mandated separation of powers. To the extent that Defendants have included improper suballocations in the Section 332 assessment, they have usurped the power of taxation, which is vested solely in the Legislature.

The assessments also constitute improper *ad valorem* taxes, illegal takings, and violate the Equal Protection Clause. Finally, they fail to meet constitutional requirements for the imposition of a tax.

Plaintiff, insurers, including the members of Plaintiff New York Insurance Association, Inc., are entitled to a refund of all monies paid by them due to the Section 332 suballocations, including those amounts swept into the General Fund.[2]

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[2] Plaintiffs do not challenge Section 332. It is recognized that the State may charge the costs of regulation back on the regulated entities. Plaintiffs only challenge the increases to the Section 332 assessments caused by the suballocations.

STATEMENT OF FACTS

I. The Parties

Plaintiff, New York Insurance Association, Inc. ("NYIA"), is a non-profit trade association of property and casualty insurance companies, both domestic and non-domestic, which issue insurance policies throughout the State of New York. (*See* Affirmation of David E. Nardolillo, dated November 22, 2013 ("Nardolillo Aff.") ¶4 Ex. B. ("Pl. 2nd Am. Compl.") ¶1.) NYIA brings this action on behalf of its thirty-seven members which pay the annual Section 332 assessment. (Pl. 2nd Am. Compl. ¶1.) Six of those members join NYIA as named Plaintiffs. (Pl. 2nd Am. Compl. ¶¶2-7.) NYIA, on behalf of its members, and these six companies, are collectively referred to as "Plaintiffs."

Plaintiffs are joined by a number of Intervenor-Plaintiffs, led by the New York Health Plan Association, Inc. ("HPA") (*see* Intervenor-Plaintiffs 2nd Am. Compl. ¶14). The other Intervenor-Plaintiffs consist of health insurer or health maintenance organization members of HPA. (Intervenor-Plaintiffs 2nd Am. Compl. ¶¶15-31.)

The Defendants in this case are various New York State officials, including Andrew M. Cuomo, Governor of the State of New York; Benjamin M. Lawsky, the Superintendent of the New York State Department of Financial Services; and Robert L. Megna, Director of Budget. (Pl. 2nd Am. Compl. ¶¶9-11.) The State of New York is also a named Defendant. (Pl. 2nd Am. Compl. ¶8.)

II. Prior Proceedings

This lawsuit commenced on January 13, 2010, when Plaintiffs filed their summons and complaint. Intervenor-Plaintiffs were permitted to file their own complaint by this Court's order dated March 10, 2010 (*See* Nardolillo Aff. ¶5 Ex. C).

Defendants answered both complaints and moved for summary judgment on June 9, 2010. (*See* Nardolillo Aff. ¶6 Ex. D.) That motion was made upon a memorandum of law, two sworn affidavits--

one from Mark E. Daigneault, the Director of the Bureau of Taxes and Accounts for the SID (Nardolillo Aff. ¶ 7 Ex. E ("Daigneault Aff.")), and one from Mary Beth LaBate, the First Deputy Director of the New York State Division of Budget (Nardolillo Aff. ¶8 Ex. F ("LaBate Aff."[3]))--and multiple documents attached thereto.

Upon the Plaintiffs' cross-motion, this Court ordered that Defendants' motion for summary judgment be stayed pending the completion of discovery. (*See* Nardolillo Aff. ¶9 Ex. G.) Defendants later withdrew their summary judgment motion, but their position was fully memorialized. Thus, those summary judgment motion papers are the basis for Plaintiffs' statements here about Defendants' arguments. Since that time, the parties have completed discovery which included the exchange of documents, the service of and response to interrogatories, and the deposition testimony of various state officials.

During the course of this lawsuit, Plaintiffs and Intervenor-Plaintiffs have filed two amended complaints. Plaintiffs' Second Amended Complaint, was filed on January 15, 2013 (Nardolillo Aff. ¶4 Ex. B). Defendants filed their answer to Plaintiffs' Second Amended Complaint on April 11, 2013 (Nardolillo Aff. ¶10 Ex. H). The parties all now concurrently move for summary judgment.

III. Applicable Statute

Suballocations involve planned expenditures of other state agencies that are put into the SID budget so that those costs can be passed on to domestic insurers. The suballocated programs remain in the agency in which they rightfully belong, such as the Department of Health. The employees and the other-than-personal service all remain with the suballocated agency; this lawsuit arises because those costs are changed on paper to SID so that they are passed on to domestic insurers under Insurance Law

[3] References here to affidavits are those affidavits submitted by Defendants in support of their previous summary judgment motion, which was later withdrawn.

Section 332. The budgetary appropriations are then "suballocated" to the agencies, so that they can spend the funds for their purposes, not for SID's purposes. The suballocations are challenged on several statutory and constitutional grounds, most relating to their true nature as illegally imposed taxes, rather than limited regulatory assessments.

During the period of this lawsuit, Insurance Law § 332 governs the assessments and sets the parameters of what may be charged to insurers.[4] The title of Section 332 is "Assessments to defray operating expenses of department." The statute permits Defendant Lawsky to "assess," pro rata, the "***expenses of the department***, excluding the expenses of the supervision of employee welfare funds, for any fiscal year, ***including all direct and indirect costs***, as approved by the director of the budget and audited by the comptroller . . . ." N.Y. Ins. Law § 332(a) (McKinney 2012) (emphasis added). The assessment is only charged to domestic insurers and "all licensed United States branches of alien insurers domiciled in this state," thus excluding companies that are licensed to write policies in New York State, but have no physical presence within it. The assessments are collected quarterly and any company which is determined to have overpaid, after the final pro-rata shares of the operating expenses are confirmed, has the option of a refund or a credit for the next fiscal year. N.Y. Ins. Law § 332(b) (McKinney 2012).

Insurance Law § 332 provides in full:

> Assessments to defray operating expenses of department
>
> (a) The ***expenses of the department***, excluding the expenses of the supervision of employee welfare funds, for any fiscal year, ***including all***

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[4] Section 332, N.Y. Ins. Law § 332 (McKinney 2012), is the governing law for the period of this lawsuit, which covers assessments through fiscal years 2011-2012. However, beginning in fiscal year 2012-2013, Financial Services Law § 206 will be the law governing the assessments. (*See* page 27, *infra*) This is a result of the combination of SID and the Banking Department. Financial Services Law § 206 is not part of this lawsuit because the 2012-2013 assessment amounts are not yet final.

direct and indirect costs, as approved by the director of the budget and audited by the comptroller, except as otherwise provided by sections one hundred fifty-one and two hundred twenty-eight of the workers' compensation law and by section sixty of the volunteer firefighters' benefit law, ***shall be assessed by the superintendent pro rata upon all domestic insurers and all licensed United States branches of alien insurers domiciled in this state*** within the meaning of paragraph four of subsection (b) of section seven thousand four hundred eight of this chapter, in proportion to the gross direct premiums and other considerations, written or received by them in this state during the calendar year ending December thirty-first immediately preceding the end of the fiscal year for which the assessment is made (less return premiums and considerations thereon) for policies or contracts of insurance covering property or risks resident or located in this state the issuance of which policies or contracts requires a license from the superintendent; and the superintendent shall levy and collect such assessments and pay the same into the ***state treasury***, subject to the provisions of section one hundred twenty-one of the state finance law and subsection (b) hereof.

(b) For each fiscal year commencing on or after April first, nineteen hundred eighty-three, a partial payment shall be made by each insurer subject to this section in a sum equal to twenty-five per centum of the annual expenses assessed upon it for the fiscal year as estimated by the superintendent. Such payment shall be made on March tenth of the preceding fiscal year and on June tenth, September tenth and December tenth of each year, or at such other dates as the director of the budget may prescribe. Provided, however, that the payment due March tenth, nineteen hundred eighty-three for the fiscal year beginning April first, nineteen hundred eighty-three shall not be required to be paid until June tenth, nineteen hundred eighty-three. The balance of assessments for the fiscal year shall be paid upon determination of the actual amount due in accordance with the provisions of this section. Any ***overpayment*** of annual assessment resulting from complying with the requirements of this subsection ***shall be refunded or at the option of the assessed applied as a credit*** against the assessment for the succeeding fiscal year. The partial payment schedule provided for herein shall not be applicable to any insurer whose annual assessment pursuant to this section for the fiscal year is estimated to be less than one hundred dollars and such insurers shall make a single annual payment on or before September thirtieth of the fiscal year.

(Emphasis added.) Thus, pursuant to current Insurance Law § 332, all domestic insurers are required to pay an annual assessment in order to defray the direct and indirect operating costs of the SID in regulating insurers.

V. The Growth of the Assessments and Their Use for the Defendants' Deficit Reduction Plan

In fiscal year 1994 – 1995, the entire SID budget was $86,669,200, with only $4,465,800 of that being suballocated to other state agencies, to pay for just six programs. (*See* Nardolillo Aff. ¶11 Ex. I, pp. 206-207.) By 2003-2004, the SID budget ballooned to $147,398,000, all to be funded by the Section 332 assessment, and the suballocated programs, now 16 in number, totaled $49,389,000 of the budget. (*See* Nardolillo Aff. ¶12 Ex. J, pp. 175, 177.) SID's fiscal year 2011-2012 budget, the most recent, contained over $304,339,363 in suballocations alone. (*See* Nardolillo Aff. ¶13 Ex. K.)

Within this trend, fiscal year 2008-2009 marked a period of tremendous growth in the insurance assessment stemming from Defendants' abuse of the suballocations. The initial SID budget, enacted on April 23, 2008, totaled $340,558,000, with $100,000,000 to be drawn from the New York State General Fund to fund the "Timothy's Law" program[5] and another $150,000 in federal funds for a risk pool study, with the remainder to be financed by the Section 332 assessment. (*See* Nardolillo Aff. ¶14 Ex. L, p. 364). The SID budget now included suballocations for 24 programs totaling $111,504,000, representing a $41,226,000 increase over the previous year.

Despite this increase, the growth in the 2008 – 2009 Section 332 assessment was not over. On February 3, 2009, then Governor Patterson, Senate Majority Leader Smith, and Speaker of the Assembly Silver issued a joint statement announcing the Deficit Reduction Plan ("DRP") (*See* Nardolillo Aff. ¶15 Ex. M, Bates No.[6] 3900; *see also* Chapter 1 of the Laws of 2009), which closed a $1.6 billion deficit for Fiscal Year 2008-2009 and also addressed a projected deficit for the following year. The DRP press

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[5] Timothy's Law reimburses small employers with 50 or fewer employees for providing mental health insurance coverage equal to the physical health coverage provided by the employer and requires such mental health parity for health plans sold in New York State.

[6] "Bates No." refers to the stamped number in the lower right hand corner of the document, which was affixed by Defendants to documents they produced in discovery in this matter.

release touted the savings from off-loading certain programs onto the Section 332 assessment, and thus onto the Plaintiffs:

> **Change HMO Direct Pay Financing.** This action will finance, through insurance assessments, the cost of the HMO Direct Pay program. This program provides "stop-loss" funds to Health Maintenance Organizations by assuming liability for costs above a certain level to help stabilize the premiums for policy holders who directly purchase insurance coverage. *(2008-09 Savings: $40 million; 2009-10, Savings:, $40 million)*
>
> . . .
>
> **Change Healthy NY Financing.** The Healthy NY program provides a subsidy to eligible small businesses to help them provide health insurance to their employees. Workers whose employers do not provide health insurance may also purchase coverage through Healthy NY. Healthy New York will now be financed through an insurance assessment. *(2008-09 Savings: $137 million; 2009-10 Savings: $137 million).*

(Nardolillo Aff. Ex. M, Bates No. 3903). Not mentioned in the press release was the off-load of another program to the Section 332 Assessment, the $1,960,000 pilot program for entertainment industry employees, which subsidized COBRA payments for unemployed entertainment industry workers in New York. (*See* 2008-2009 Budget, Nardolillo Aff. Ex. L, p. 40.)

The DRP had a retroactive effective date of April 1, 2008, resulting in an immediate $180,633,600 increase in the Section 332 assessment to be split among the covered insurers, for a total assessment amount of $421,041,600, or more than double the previous budget year's assessment. These programs have remained in the Section 332 suballocations ever since.

The DRP off-loads to the Section 332 assessment were part of a larger practice of off-loading General Fund expenses to other special revenue funds. This practice did not go unnoticed by the New York State Comptroller who, in April 2010, issued a report entitled "New York's Deficit Shuffle" labeling the use of such off-loads as "fiscal manipulations" which served to "distort the state's financial picture." (Nardolillo Aff. ¶16 Ex. N, p. 1.) This report will be discussed in further detail on pages 34-35,

infra.

VI. "Sweeps" of Assessment Monies into General Fund

In addition to the off-loads, Defendants diverted $89,360,000 of unspent suballocations from the Section 332 assessment fund to the General Fund, through a series of actions known as "sweeps". The first such "sweep" of the Section 332 fund was part of the DRP (*see* Nardolillo Aff. Ex. M, Bates No. 3904). On February 4, 2009, the Legislature enacted a law that directed the Comptroller to respond to a request from the Director of Budget to transfer $4,500,000 in unused Section 332 assessments into the State General Fund. *See* L. 2009, Ch 2, Part H, § 1. That law provided in pertinent part:

> Notwithstanding any law to the contrary, the insurance department shall finance the annual expenses related to its activities and operations through assessments on all regulated entities of the department. For state fiscal year 2008-09, the total value of the annual assessment will be equal to the total value of the department's enacted appropriations. ***In such instances where the total value of the annual industry assessment exceeds the actual annual expenses of the department's operations and activities, in accordance with section 4 of the state finance law, the comptroller is hereby authorized and directed to transfer, at the request of the director of the budget, up to $4.5 million from the unencumbered balance of the insurance department account (339.B6) to the general fund in state fiscal year 2008-09.***

(Emphasis added). This statute, unlike in previous budget years, automatically set the amount of the assessment at the total amount of the appropriations enacted, as opposed to the normal practice of using estimated and actual costs. This type of statute is referred to as a total enacted appropriations or "TEA" statute. On February 17, 2009, Defendants transferred $4,500,000 to the General Fund pursuant to that section. (*See* Nardolillo Aff. ¶17 Ex. O ("Def. Resp. to Second Set of Interrogatories"), p. 8.)

Defendants followed that transfer with five additional sweeps of unused assessments into the General Fund, totaling, $84,862,000. First, pursuant to Chapter 56 of the Laws of 2009, Part PP, §2,

subd. 4, Defendants swept $15,000,000 of unused Section 332 assessments into the General Fund. (Def. Resp. to Second Set of Interrogatories, p. 8.) Then, under Chapter 503 of the Laws of 2009, Part E, §3, which allowed Defendants to sweep ***any*** special revenue fund, not just the Section 332 assessment, Defendants diverted a full $50,000,000 in unused assessments to the General Fund. (Def. Resp. to Second Set of Interrogatories, p. 8.) Defendants also swept $4,940,000 into the General Fund under Chapter 503 of the Laws of 2009, Part E, § 5 which was another TEA statute setting the assessment amount; $9,922,000 under Chapter 56 of the Laws of 2010, Part JJ, § 9; and $5,000,000 under Chapter 56 of the Laws of 2010, Part JJ, § 14. (Def. Resp. to Second Set of Interrogatories, p. 8-9.)

These sweeps also did not go unnoticed by the New York State Comptroller, who slammed their use as a "fiscal shell game" which masked the State's true fiscal conditions. *See* pp. 34-35, *infra.*

VII. Description of the Suballocated Programs and Appropriations Charged Via Section 332

The suballocated programs funded by the insurance assessment cover a broad spectrum of activities that have no connection to the SID's regulatory activities. Defendants have grouped the suballocated programs into two categories: the programs that they claim are the direct costs of the SID, and the programs that they claim are indirect costs.

The programs charged to insurers through Section 332 that the Defendants have claimed as the direct costs of SID include the following programs: the Office of the Inspector General, the Healthy New York Program, the Health Maintenance Organization Direct Pay Market Program, and the Pilot Program for Entertainment Industry Employees. (*See* LaBate Aff. ¶19.) Defendants claim that these programs qualify as direct costs because they are "programs administered by the Department to provide New Yorkers with affordable insurance coverage, which is one of the Department's most important functions." (LaBate Aff. ¶18.) While the cost of these programs are imposed upon all domestic insurers, whatever relationship they may have with health insurers, they have no such relationship with

property and casualty insurers.

The Healthy New Program subsidizes the insurance premium payments made by New York small business owners and low income New York State residents in order to lower their health insurance costs (*See* LaBate Aff. ¶ 21). The HMO Direct Pay Program subsidizes health maintenance organizations to offset claims made by qualified insureds for the costs of health services. (LaBate Aff. ¶ 22.) The Pilot Program for Entertainment Industry Employees, also shifted to the Section 332 assessment under the DRP, serves to subsidize COBRA health insurance premiums for unemployed members of the entertainment industry. (LaBate Aff. ¶26.)

On the other hand, the Defendants have claimed the suballocations to the Banking Department, the Department of State, the Department of Health, the Department of Law, and the Division of Criminal Justice Services as indirect costs of SID because they argued that these suballocations "relate to the conduct of insurance business and the regulatory concerns of the Department" and

> "fund programs which further the Department's functions of, *inter alia*, ensuring the fair treatment of insurance policyholders and claimants, regulating insurance companies and rates, keeping insurance available and affordable for all consumers in New York, keeping the costs of such insurance coverage down, diminishing the occurrence and magnitude of claims filed against insurers; and addressing costs resulting from the filing of false and fraudulent claims."

(LaBate Aff. ¶ 27.)

The suballocation to the Banking Department was for the Holocaust Claims Processing Office ("HCPO"), which assists persons to recover monies never paid in connection with insurance policies issued by European insurers. In its January 15, 2009 annual report, the HCPO noted that, from its inception, it has assisted with insurance claims made by individuals from 42 states and 24 countries.

The Insurance Department also made suballocations to the Department of State for the following self-explanatory programs:

> (1) the enforcement, development, and maintenance of the state building code; (2) the urban search and rescue program; (3) the fire prevention and control program-and the state fire reporting system; (4) developing and promulgating fire safety standards -for cigarettes; (5) repair and rehabilitation of the state fire training academy; (6) fire inspections and fire safety training programs at privately operated colleges and universities in New York State; and (7) payments related to municipalities fighting fires on state property, expenses incurred under the state's fire mobilization and mutual aid plan, and for payment of training costs incurred for training of certain first-'line supervisors of paid fire departments.

(LaBate Aff. ¶ 32.)

The Insurance Department also made a myriad of suballocation payments to the Department of Health for:

> (1) the development of inpatient hospital rates for insurance payments; (2) the certification of managed care programs; (3) the approval of managed care implementation plans; (4) the center for community health program; (5) the implementation of a forge-proof pharmaceutical prescription program; (6) the enhanced newborn screening program; (7) the cervical cancer vaccine program; (8) the lead poisoning prevention program; (9) the childhood lead poisoning primary prevention program; (10) the lead prevention program; (11) the childhood obesity program; and (12) the immunization program.

(LaBate Aff. ¶ 42.) The development of inpatient hospital rates for insurance programs involves the Department of Health's setting of hospital reimbursement rates for no-fault automobile insurance payments. DOH also manages the certification of managed care programs and the approval of managed care implementation plans which deal with Medicaid managed care plans. The Center for Community Health programs are payments to local agencies for local public health programs. DOH's cervical cancer vaccine program supports outreach and education to promote the availability of the vaccine and funds vaccination to help prevent the occurrence of several types of cervical cancer.

Similarly, the Department of Health's immunization program provides vaccines to health care providers for administration free of charge to eligible children. Like the Centers for Community Health suballocation, the suballocations for lead poisoning prevention, childhood lead poisoning primary

prevention, and lead prevention fund programs are paid to local health departments, which administer the educational and outreach programs on lead poisoning. The DOH's childhood obesity program is an outreach program geared toward improved nutrition and increased physical activity. The enhanced newborn screening program is another DOH program; it is required under the Public Health Law, and screens newborns for a variety of medical conditions. Finally, the forge-proof pharmaceutical prescription program is simply a suballocation to the Department of Health for the printing of prescription forms for use by New York practitioners and healthcare facilities, which purportedly reduces the risk of fraudulent prescription forms being used to obtain controlled substances. (LaBate Aff. ¶ 47.)

The suballocation to the Department of Law pays the Office of the Attorney General for services and expenses associated with the no-fault automobile insurance fraud unit and the investigation of broker/insurer practices in the insurance industry. (LaBate Aff. ¶ 48.)

Finally, the assessment also includes a suballocation to the Division of Criminal Justice Services for a program called the Traffic and Criminal Software Project. This program was developed in conjunction with the New York City Police Department to allow its members to electronically prepare accident reports and traffic tickets and electronically transmit the completed forms to the Department of Motor Vehicles for inclusion in a statewide database. (LaBate Aff. ¶ 49.)

What stands out about all the suballocated programs is that while they all may be worthy pursuits for the State of New York, none of them is a program necessary for the regulation of domestic insurers, and none of them encompasses operating expenses of the State Insurance Department. They are all undertaken for the benefit of the general public, or of selected groups, but not for the benefit of domestic property and casualty insurers specifically, or domestic insurers generally. The nature of the suballocations as general welfare programs is more fully set forth in the accompanying Affirmation of Jeffrey J. Sherrin, dated November 22, 2013 ("Sherrin Aff.").

ARGUMENT

SUMMARY JUDGMENT STANDARD

The standard for summary judgment is well settled: a court may grant summary judgment under CPLR § 3212 where there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. CPLR § 3212. The proponent of a summary judgment motion must make a *prima facie* showing of entitlement to judgment as a matter of law, tendering sufficient evidence to demonstrate the absence of any material issues of fact.

Once a *prima facie* showing has been made that no genuine issue of fact exists, the burden shifts to the opposing party who "must produce evidentiary proof in admissible form sufficient to require a trial of material questions of fact[.]" *Zuckerman v. City of New York*, 49 N.Y.2d 557, 562 (1980). Mere conclusions or unsubstantiated allegations are insufficient to raise a triable issue of fact. *Frank Corp. v. Federal Ins. Co.*, 70 N.Y.2d 966 (1988).

There are no material issues of fact in this matter. The nature and functions of the suballocated programs contained within the Section 332 assessment are not in dispute, and neither are the amounts and timing of the sweeps of unused assessments into the General Fund. Therefore, the issue is whether the Plaintiffs are entitled to judgment as a matter of law. As detailed below, it is clear that the Section 332 assessments for the suballocations are improper and Plaintiffs are entitled to recover the amounts they have paid for those suballocations.

POINT I

THE SECTION 332 ASSESSMENTS ARE NOT PROPER REGULATORY FEES BECAUSE THE CHARGED PROGRAMS DO NOT MEET THE DEFINITIONS OF ASSESSABLE COSTS UNDER SECTION 332

The Section 332 assessments do not constitute valid regulatory fees or assessments, but rather taxes.

New York State agencies may assess regulatory fees, but those fees must be "reasonably necessary to the accomplishment of the regulatory program" and bear "a rough correlation to the expense to which the State is put in administering its licensing procedures or to the benefits those who make the payments receive." *Walton v. New York State Dept. of Correctional Services*, 13 N.Y.3d 475, 485 (2009) (quoting *Suffolk County Bldrs. Ass'n v County of Suffolk*, 46 N.Y.2d 613, 619 (1979)). Typically, fees are paid to obtain access to a government service or benefit, such as the fees paid to obtain licenses to practice professions in particular jurisdictions. *See Walton*, 13 N.Y.3d at 485. If a purported regulatory fee does not meet the above conditions, it will be generally be deemed a tax and analyzed as such under the relevant statutes and the State and Federal Constitutions.

Furthermore, courts tend to find that fees claimed as regulatory assessments are actually taxes when a legislative enactment is intended to generate revenue rather than to regulate a given entity. *Colonial Life Ins. Co. of Am. v. Curiale*, 205 A.D.2d 58, 63 (3d Dep't 1994), *citing, inter alia, San Juan Cellular Tel. Co. v. Public Serv. Commn.*, 967 F.2d 683 (1st Cir. 1992). Unlike a regulatory fee, a tax is a charge that a government exacts from a citizen to defray the general costs of government unrelated to any particular benefit received by that citizen. *Walton,* 13 NY3d at 485 (internal citations omitted).

Here, the Section 332 assessments, to the extent they exceed the necessary regulatory costs due to the suballocations, are not valid regulatory fees because the costs of the suballocated programs that are charged to insurers are not assessable costs under the statute., Furthermore, the General Fund

sweeps, the manner in which defendants treat the suballocations in the budgeting process, and the manner in which the suballocations are spent only serve to underscore how far the Section 332 assessments have drifted from their intended use to defray the expenses of the SIDs regulatory activities and into the realm of a general revenue tax. The Defendants' position on why the suballocated programs are properly assessed through Section 332 was a creation in response to Plaintiffs' lawsuit and relies on a standard that has been rejected by multiple courts and is so broad that any state program would fall within it.

A. The Proper Definitions of Operating Expenses, Direct Costs And Indirect Costs for Section 332

The New York Insurance Law does not define operating expenses, direct costs, or indirect costs in Section 332 or elsewhere. However, these terms have specific and universally accepted meanings within the context of public cost accounting and budgeting.

1. Operating Expenses

Pursuant to Insurance Law § 332, Defendants may only assess the Plaintiffs and Intervenor-Plaintiffs for the SID's direct and indirect operating expenses. As its title suggests, Section 332 only provides the Insurance Department the ability to "defray [the] ***operating expenses*** of [the] department." The items that may be assessed upon covered insurers are limited to the "expenses of the department," and a plain reading of the statute mandated that the "direct and indirect costs" of the SID must be expenses of the department for those items to be properly assessable under the statute. N.Y. Ins. Law § 332(a) (McKinney 2012); *see also* Daigneault Aff. ¶ 21 (SID issues Section 332 assessments "to obtain the expenses of the Department, both direct and indirect costs.")

According to Mary Beth LaBate, the First Deputy Budget Director (*See* Nardolillo Aff. ¶18 Ex. P, Examination Before Trial of Mary Beth LaBate ("LaBate Dep."), 6:3-5), there are some expenses that

are categorized as operating expenses and other expenses that are categorized as non-operating expenses. The term "operating expense" is limited to something that was an "expense of an agency to run its operations." (LaBate Dep. 18:4-5.) Similarly, Edward Cahill, the Director of the Bureau of Budget Management for the Department of Health (*see* Nardolillo Aff. ¶19 Ex. Q, Examination Before Trial of Edward Cahill ("Cahill Dep."), 5:19-23), defined the term "operating cost" as "the cost that the program has to proceed in doing its functions." (Cahill Dep. 17:10-14.)

Necessarily, items included in the category of "aid to localities," a major sub-category of the suballocated programs, are not considered to be operating expenses. (*See, e.g.* LaBate Dep. 18:14-20; 19:8-11.) "Aid to localities" is money given out to local governments and not-for-profit groups, or anything that is not directly going to another state entity. (*See* LaBate Dep. 18:9-13.) Monies that constitute aid to localities may appear in a state agency's budget, but not as operating expenses, because those funds are "not used to turn on the lights, buy pencils, pay salaries." (*See* LaBate Dep. 18:14-20.) Nevertheless, the challenged assessments include hundreds of millions of dollars in aid to localities.

2. Direct and Indirect Costs

The universally-accepted definitions of direct and indirect costs are expressed in the White House Office of Management and Budget ("OMB") Circular A-87, 70 Fed. Reg. 51910 (Aug. 31, 2005) (*see* Nardolillo Aff. ¶20 Ex. R ("Circular A-87")), codified at 2 C.F.R. § 225.25 (2005). This document, entitled "Cost Principles For State, Local, and Indian Tribal Governments," is used in cost accounting for grant proposals utilizing federal funds. The stated purpose of Circular A-87 is to establish "principles and standards for determining costs for Federal awards carried out through, grants, cost reimbursement contracts, and other agreements with State and local governments and federally

recognized Indian tribal governments." 2 C.F.R. § 225.5[7] (Circular A-87, p. 51910).

Circular A-87 defines direct costs as follows:

> E. Direct Costs
>
> 1. General. Direct costs are those that can be identified specifically with a particular final cost objective.
>
> 2. Application. Typical direct costs chargeable to Federal awards are:
>
> a. Compensation of employees for the time devoted and identified specifically to the performance of those awards.
> b. Cost of materials acquired, consumed, or expended specifically for the purpose of those awards.
> c. Equipment and other approved capital expenditures.
> d. Travel expenses incurred specifically to carry out the award.

2 C.F.R. § 225 App. A (*see* Circular A-87, p. 51913). Under this definition, direct costs are the costs for employee salaries and benefits, which can include health insurance and retirement plan contributions; materials and equipment such as office supplies, building rent, and utilities; and other costs that can be directly connected to a program, such as travel expenses.

Circular A-87 also defines indirect costs:

> F. Indirect Costs
>
> 1. General. Indirect costs are those: Incurred for a common or joint purpose benefiting more than one cost objective, and not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved. The term "indirect costs," as used herein, applies to costs of this type originating in the grantee department, as well as those incurred by other departments in supplying goods, services, and facilities. To facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect costs within a governmental unit department or in other

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[7] Circular A-87 falls within OMB's authority to provide government-wide policy guidance to federal agencies (*see* 31 U.S.C. § 1111(2); Executive Order No. 11,541, § 1), and the principles contained in Circular A–87 date back to 1968 when the predecessor agency to OMB issued Federal Management Circular 74–4. *See Arizona v. Shalala*, 121 F. Supp. 2d 40, 46 n.3 (D.D.C. 2000). Federal Management Circular 74–4 became known as Circular A-87 in January 1981. *See* 46 Fed. Reg. 9548 (Jan. 28 1981). Unless otherwise stated, all references to Circular A-87 will be to the 2005 version, 70 Fed. Reg. 51910 (Aug. 31, 2005) codified at 2 C.F.R. § 225.25 (2005).

> agencies providing services to a governmental unit department. Indirect cost pools should be distributed to benefitted cost objectives on bases that will produce an equitable result in consideration of relative benefits derived.

2 C.F.R. § 225 App. A (*see* Circular A-87, p. 51913). Fundamentally under Circular A-87, indirect costs are costs of other state agencies which provide various support and services to multiple agencies, including the agency receiving the grant. These costs cannot be directly apportioned to a particular agency, otherwise they would be categorized as direct costs. These state agencies are compensated for those services through "[c]ost allocation plans and indirect cost proposals" which must meet governmental requirements *see* 2 C.F.R. § 225 App. A (Circular A-87, p. 51913); App. C (Circular A-87, p. 51922); App. E (Circular A-87, p. 51924).

Circular A-87 also forbids items being claimed as indirect costs if the same cost has already been designated as a direct cost, which is exactly what Defendants are doing here with the suballocated costs. Circular A-87 provides in relevant part: "A cost may not be allocated to a Federal award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to a Federal award as a direct cost." 2 C.F.R. § 225 App. E (Circular A-87, p. 51924). This provision precludes inconsistent treatment of costs and double charging of costs to multiple programs.

In addition to the defined requirements of direct and indirect costs, Circular A-87 also presents an overarching mandate of reasonableness, which is also defined.

> 2. Reasonable costs. ***A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost.*** The question of reasonableness is particularly important when governmental units or components are predominately federally-funded. In determining reasonableness of a given cost, consideration shall be given to:
>
> > a. Whether the cost is of a type ***generally recognized as ordinary and necessary for the operation of the governmental unit*** or the performance of the Federal award.
> >
> > b. The restraints or requirements imposed by such factors as: Sound business

practices; ***arm's-length bargaining; Federal, State and other laws and regulations***; and, terms and conditions of the Federal award.

c. Market prices for comparable goods or services.

d. Whether the individuals concerned acted with prudence in the circumstances ***considering their responsibilities to the governmental unit, its employees, the public at large***, and the Federal Government.

e. ***Significant deviations from the established practices of the governmental unit*** which may unjustifiably increase the Federal awards cost.

2 C.F.R. § 225 App. A (Circular A-87 51912-51913) (emphasis supplied). These standards importantly require a test of reasonableness even if a cost falls within the technical definition of a direct or indirect cost. Circular A-87 disqualifies costs which do not meet these requirements. *See also AAB II* Decision and Order (Nardolillo Aff. Ex. A) at p. 11 (relying on OMB Circular A-87 in holding that costs must meet a standard of reasonableness in order to be chargeable under a statute similar to Section 332).

B. The Proper Definitions of the Terms in Section 332 Are Consistent Across Federal and State Cost Accounting

Although Circular A-87 applies to federal grants, deposition testimony and documents produced by Defendants demonstrated that the identical Circular A-87 meanings of "direct costs" and "indirect costs" are accepted and employed by the Defendants themselves in the context of New York State government cost accounting.

Mr. Cahill testified that the definition of direct costs that he applied in his job was the same as that appeared in Circular A-87. (*See* Cahill Dep. 23:17-23:21).[8] Lori Fraser, who prepared the Insurance Department's budget (*See* Nardolillo Aff. ¶21 Ex. S, Examination Before Trial of Lori Fraser ("Fraser Dep.") 05:14-19), understood direct costs as something that would be "specifically identified" to a

[8] "Exhibit 3" identified in the deposition of Mr. Cahill contains Circular A-87, attached as Exhibit R to the Nardolillo Affirmation.

"specific cost" objective and cited rent payments as an example of a direct cost. (*See* Fraser Dep. 36:14-19.) This understanding matched Circular A-87, which defined direct costs as costs "that can be identified specifically with a particular final cost objective." This definition was widely understood and Mr. Cahill was not aware of any publication which contained a different definition of direct costs other than what was contained in Circular A-87. (Cahill Dep. 24:11-15).

The deponents also confirmed that the Circular A-87 definition of indirect costs was identical to the same definitions used in New York State cost accounting. According to Circular A-87, indirect costs are the costs of organizations or agencies that provide services to the governmental unit. In the case of New York State, there are central service state agencies ("CSSAs"), which provide various services to all New York State agencies.[9] The costs incurred by the CSSAs for the provision of the services attributable to the remaining line agencies are treated as the indirect costs of the remaining line agencies. (*See* LaBate Dep. 34:9 – 12.) In concert with this definition, Ms. Fraser defined "indirect costs" as those costs that go to support other central service state agencies such as the Office of General Services and the Attorney General's Office for services that they provide to the Insurance Department. (Fraser Dep. 37:13-22). Central Service State Agency costs are properly assessed to SID and other line agencies via their "indirect cost rate." (*See* LaBate Dep. 34:13-16; Fraser Dep. 37-38.) The Division of Budget develops the rate, which is a percentage figure (*see* Fraser Dep. 122:13-15; 128:19-22), that is then multiplied by the personal service costs of the agency in question. The resulting calculation is the amount of indirect costs that the line agency must pay. (*See* Fraser Dep. 71:10-17; 72:7-11.)

All of the State witnesses testified that the definitions of direct and indirect costs found in

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[9] For fiscal year 2009-2010, there were 12 Central Service State Agencies ("CSSAs"): the Office of General Services, the Office of the State Comptroller, the Division of the Budget, the Office of Employee Relations, the Department of Law, the Division of Minority and Women Owned Businesses, Department of State, the Office for Technology, the Governor's Office of Regulatory Reform, Treasury Management, the Public Employment Relations Board, and the Office of the Inspector General. (*See* Nardolillo Aff. ¶22 Ex. T, Bates No. 17303.)

Circular A-87 matched the definitions employed at the state level. (Fraser Dep. 42:8-22,[10] 43:9 to 44:13; Cahill Dep. 19:10-15), and that they were not aware of any other definition of indirect costs that was employed in State cost that would differ from the definition in Circular A-87 (Fraser Dep. 44:6-18, Cahill Dep. 25:20-24).

Similarly, the New York State Accounting System User Procedures Manual, issued by the Comptroller ("OSC"), employs a definition of indirect costs consistent with Circular A-87:

> Indirect costs are agency or central service agency costs that cannot be directly associated with the administration of a particular program and therefore cannot be charged as a direct program expense. Indirect costs include, but are not limited to, physical overhead, space occupancy, utilities, information technology and central service agency (e.g. OGS, Civil Service, Budget, General Services, etc.) costs.

(*See* Nardolillo Aff. ¶23 Ex. U, Bates No. 1636.[11]) This document is accepted and applied by SID (Fraser Dep. 39:2-40:5, LaBate Dep. 46:18 to 47:18[12]), and the Department of Health . (Cahill Dep. 21:2-7, 19:15-19, 19:20 through 20:5.). He also testified that the definitions of "indirect costs" were the same in both Circular A-87 and the OSC manual and that he applied the OSC manual definition in his job. (Cahill Dep. 21-23)

Numerous other DOB documents confirm that, when not trying to justify in litigation an indefensible position of what an indirect cost is, the Defendants were well aware of and employed in the normal course of business the universally-accepted meaning of the term. (*See* Nardolillo Aff. ¶25 Ex. W, Bates Nos. 20010- 20011.) This same definition also seen in internal Division of Budget memoranda,

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[10] "Exhibit 3" identified in the deposition of Ms. Fraser contains Circular A-87, Which is attached as Exhibit R to the Nardolillo Affirmation..

[11] This document was identified as "Plaintiffs' Exhibit 2" in Ms. Fraser's deposition.

[12] "Exhibit 9" identified during Ms. LaBate's deposition contains a copy of the identical users procedure in Exhibit U in the Nardolillo Affirmation. A copy of that Exhibit 9 is also attached to the Nardolillo Affirmation. (*See* ¶ 24 Ex. V, pp .19652-19655.

known as "tech memos" (LaBate Dep. 52), such as Technical Memorandum 9-29. (*See* Nardolillo Aff. ¶26 Ex. X, Bates No. 21911). Moreover, Ms. LaBate even instructed other Division of Budget employees to follow this precise Tech Memo (*See* Nardolillo Aff. ¶27 Ex. Y, Bates No. 21059; LaBate Dep. 51-52; 58:1-6), which was used for state budgeting purposes (LaBate Dep. 58:15-20.) (*See also* Nardolillo Aff. ¶28 Ex. Z, Bates Nos.7805 to 7826). The technical memorandum for each successive year contained the exact same definition of indirect costs. (*See* Nardolillo Aff. Ex. Z, Bates No. 7810 (technical memorandum 06-26 for FY 2007-2008); Bates No. 7815 (technical memorandum 07-32 for FY 2008-2009); Bates No. 7819 (technical memorandum 08-40 for FY 2009-2010); Bates No. 7823 (technical memorandum 10-54 for FY 2011-2012).

Thus, New York State has consistently applied the known meaning to the term indirect costs found in Section 332, and has never adopted or used the litigation-created definition for that term which Defendants now employ to try to convert the suballocations into regulatory assessments.

C. The Legislative History of Section 332 Confirms a Definition of Operating Expenses and Indirect Costs and Limits Assessable Costs to Expenses in Regulating Persons under the Insurance Law

The legislative history of Section 332 not only confirms an understanding by the Legislature of the same limited definitions of operating expenses and indirect costs found in Circular A-87 and the OSC manual, but it also demonstrates that the Section 332 assessment was intended to only assess costs incurred in the SID's activities in regulating individuals and companies subject to the Insurance Law.

Legislative history, the "circumstances surrounding [a] statute's passage, and the history of the times" are appropriate to consider "[i]n ascertaining the purpose and applicability of a statute." N.Y. Stat. Law § 124 (McKinney). A statute's legislative history "is not to be ignored, even if words be clear." *Id.* "These aids will show the circumstances under which the statute was passed, its object and the

mischief at which it was aimed." *Id.*

"It is fundamental that a court, in interpreting a statute, should attempt to effectuate the intent of the Legislature." *Majewski v. Broadalbin-Perth Cent. School Dist.*, 91 N.Y.2d 577, 583 (1998) (internal citations omitted). "In construing statutes, it is a well-established rule that resort must be had to the natural signification of the words employed, and if they have a definite meaning, which involves no absurdity or contradiction, there is no room for construction and courts have no right to add to or take away from that meaning." *Id.* "[L]egislation is to be interpreted so as to give effect to every provision. A construction that would render a provision superfluous is to be avoided." *Majewski*, 91 N.Y.2d at 587, *citing, inter alia,* McKinney's Cons. Laws of N.Y., Book 1, Statutes § 98[a]. Further, although a statute's title is not dispositive, "[if] the legislative intent is not clearly expressed in the enactment, the courts may resort to the title as an aid in its interpretation." McKinney's Statutes § 123.

1. The History of Section 332

Since its inception, the purpose of what is now Insurance Law § 332 (former Insurance Law § 32-a, enacted in 1940), as declared by the Governor, has been to "*defray the expenses of operating* the insurance department." L. 1940, ch. 824, Governor's Bill Jacket (*see* Nardolillo Aff. ¶29 Ex. AA). Consistent with that purpose – to defray operating expenses – the memorandum from the Superintendent of Insurance to the Governor accompanying the bill depicted Section 332 expenses as including "indirect costs, such as office rent":

> Under this bill the Department would be required to assess all ***operating expenses, including indirect costs, such as office rent*** in State-owned or State-leased buildings, against all domestic insurance companies and corporations organized or authorized to do an insurance business in this State in proportion to the net premiums collected in this State over and above the amount now collected by the Department for fees and examination expenses.

L. 1940, ch. 824, Governor's Bill Jacket, Memorandum to Governor from Superintendent of Insurance

(*see* Nardolillo Aff. ¶30 Ex. BB), p. 52.

In 1970, the Attorney General issued an opinion clarifying the scope of former Insurance Law § 32-a (and similar laws covering banking and workers compensation) and concluding that "indirect costs," such as for State Central Support Services (i.e. audit, tax, legal, etc.), should be included in each department's budget for assessment purposes. 1970 N.Y. Op. Att'y Gen. 19, 6 (Apr. 13, 1970) (*see* Nardolillo Aff. ¶31 Ex. CC). The Attorney General's Opinion confirmed that "direct or indirect" agency costs were limited to "operational" costs, e.g. "Central Support Services" and other agency-supporting operations (such as audit, taxation, law, budget, etc.) but not substantive public-benefit programs that were normally and properly financed by general taxes:

> [I]t is apparent that the Legislature intended to include all State costs relative to the ***operation*** of the programs and departments involved, ***whether or not these costs were direct costs to the programs and departments involved.***

The legislative intent to recover just operating costs under former section 32-a was restated many times. *See* L. 1972, ch. 944; L. 1984, ch. 367; and L. 1989, ch. 61.

This 1989 amendment, ch.61, confirmed the true purpose behind Section 332: to cover the expenses the SID incurred in its function of regulating insurers. In support of the 1989 amendment, the Governor set forth the following reasons that the "expenses of the Insurance Department [should] be recovered solely from § 332 assessments" – namely, that regulated insurers should defray the entire ***cost of being regulated*** -- and that fees and refunds collected under other parts of the Insurance Law should be viewed as payments for the privilege of doing business in this State and should "inure to the benefit of the public":

> "The ***various revenues affected by this bill [i.e. the fees and refunds that, prior to the 1989 amendment, had funded the majority of the Department's operating costs]*** represent fees for the privilege of conducting certain types of business in New York State..." and, accordingly, should "inure to the benefit of the people of the

> State... rather than to the benefit of the ***regulated entities [in]volved who are otherwise assessed for the costs of administering these laws."***

Most recently, Section 332's successor statute even more explicitly confirmed the limitation to the assessment of operating costs. Beginning with the 2012 – 2013 fiscal year, the assessment was now governed by Section 206(a) of the New York State Financial Services Law, enacted upon the combination of the New York State Banking Department and the SID into a new single state agency, the New York State Department of Financial Services.[13] This new statute also makes it clear that the assessments must be comprised of SID's operating costs. The pertinent portion of Section 206(a) reads as follows:

> § 206. Assessments to defray ***operating expenses*** of the department
>
> > (a) For each fiscal year commencing on or after April first, two thousand twelve, assessments to defray ***operating expenses, including all direct and indirect costs,*** of the department, except expenses incurred in the liquidation of banking organizations, shall be assessed by the superintendent in accordance with this subsection. ***Persons regulated under the insurance law shall be assessed by the superintendent for the operating expenses of the department that are solely attributable to regulating persons under the insurance law***, which shall include any expenses that were ***permissible*** to be assessed in fiscal year two thousand nine-two thousand ten, with the assessments allocated pro rata upon all domestic insurers and all licensed United States branches of alien insurers domiciled in this state ... ***Operating expenses*** of the department not covered by the assessments set forth above shall be assessed by the superintendent in such proportions as the superintendent shall deem just and reasonable upon all domestic insurers and all licensed United States branches of alien insurers domiciled in this state.

The legislative history, therefore confirms that "the expenses of the department ... including all direct and indirect costs," assessable under Section 332 must be the SID's ***operating*** expenses. Since its enactment in 1940, Insurance Law § 332 has been titled: "Assessments to defray ***operating*** expenses of department." The statutory amendments in 1941, 1972, 1984 and 1989 all retained the original title, as

does the newest version of the statute, Financial Services Law § 206(a). Although the title of a statute is not controlling with respect to legislative intent, the heading of a section inserted by the Legislature does have limiting effect. Regardless of whether the introduction to Section 332 -- specifically referring to "operating" expenses, as opposed to substantive program expenses – is a "title" or a "heading, it strongly evidences the Legislature's original and longstanding intent, over 70 years, that Section 332 assessments be limited to the Department's officially approved ***operating expenses***, including direct and indirect costs, in supervising and regulating insurers.

The expression of the Legislature's intent extends far beyond the title of the statute. The originating Governor's memorandum in 1940 refers to "operating" expenses of the Insurance Department. L. 1940, ch. 824, Governor's Bill Jacket. Likewise, the 1940 memorandum from the Superintendent of Insurance to the Governor describes assessable expenses under the statute as "***operating*** expenses, including ***indirect costs, such as office rent*** in State-owned or State-leased buildings." Governor's Bill Jacket, Memorandum to Governor from Superintendent of Insurance, p. 52. Financial Services Law § 206(a), which will govern the assessment going forward, specifically states that the "operating expenses" of the SID, and only those "***that are solely attributable to regulating persons under the insurance law***" may be assessed.

Because the suballocations far exceed the scope of what was ever intended by Section 332, the Excess Assessments are null and void and must be refunded to Plaintiffs. *See Am. Ass'n of Bioanalysts v. Axelrod*, 130 A.D.2d 889 (3d Dep't 1987) (*"AAB I"*)(holding that regulatory fees in excess of the necessary costs of regulating laboratories must be fully refunded to the laboratories.)

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[13] The assessments levied under this new section are not currently at issue in this lawsuit because the final assessment bill has not yet been sent to plaintiffs. Therefore the fiscal year 2012 – 2013 insurance assessment is not final.

2. Failed Attempt to Amend Statute Confirms Limitation of Assessable Costs to Operating Expenses

Defendants knew that assessable costs are limited to operating expenses of the SID, because in 2009 they launched an ultimately unsuccessful attempt to amend Section 332 to expand the scope of the assessment as described below. This is an explicit acknowledgment of the narrow band of properly assessable costs.

Consideration of the attempted 2009 amendment is appropriate; courts may, and should, consider failed amendments in finding the meaning of a statute. *See* N.Y. Stat. Law § 124 (McKinney) ("[I]n the construction of statutes it is relevant to consider . . . attempted amendments.") The failure of amendments to be approved by the Legislature has presumptive effect. "[I]f the Legislature wished to change the interpretation of a statute, it should make an appropriate change in the language; the fact that no change in wording is made creates a presumption that no change in meaning is intended" N.Y. Stat. Law § 75 (McKinney).

Courts have cited rejections of proposed language as persuasive evidence of the Legislature's intent. In *People v. Korkala*, 99 A.D.2d 161 (1st Dep't 1984) the Appellate Division noted that the "rejection of a specific statutory provision is a significant consideration when divining legislative intent" in deciding whether to accord Shield Law protection to raw footage of an interview taped for the "60 Minutes" news program. 99 A.D.2d at 162. In that case, the court considered the legislative history of an amendment to the Shield Law and found that a provision in the initial bill, which would have accorded the footage privileged status, was deleted from the final version that was enacted. *Id.* at 165-166. The *Korkala* court found that this deletion "rather persuasively suggest[ed] the Legislature's intent was not to accord such protections under the Shield Law. *Id.*

The failed amendment in this case confirms Section 332's limitation to operating expenses. While deliberating the FY 2009-2010 budget, the Legislature considered amending the title of Insurance

Law § 332 to ***delete*** "operating" from the description of assessable SID expenses. The Amendment also sought to expand the definition of assessable SID "expenses" to include "all appropriations whether administered by the department ***or suballocated*** to another state department, board or agency." Section 119, A.158 / S.58 (January 7, 2009) (*see* Nardolillo Aff. ¶ 49 Ex. UU, p. 120). Importantly, however, these provisions were ultimately rejected; the Legislature chose to retain the preexisting title ("Assessments to defray ***operating*** expenses of department") and language.

D. The Suballocations Do Not Meet the Requirements of Section 332

Based on the proper definitions of operating expenses, direct costs, and indirect costs, as well as the requirement that the assessable expenses must be limited to the regulation of persons and companies subject to the Insurance Law, the Court must find that the challenged suballocations are not properly assessable, as they were not regulatory expenses.

1. The Nature of the Programs and the Manner in Which the Suballocations Are Spent Demonstrates that the Suballocations are Not Regulatory Expenses

The suballocations[14] also do not meet the definition of assessable costs under Section 332 because they are outside the scope of operating expenses incurred in the regulation of persons under the Insurance Law, and therefore are not reasonable costs as required by Circular A-87, because they are not "of a type generally recognized as ordinary and necessary for the operation of the governmental unit . . . ." 2 C.F.R. § 225, App. A (Circular A-87 51912-51913). *See also AAB II* Decision and Order, p. 11 (chargeable costs to clinical laboratories are limited to those "necessary and reasonable for proper and efficient performance and administration of the reference system").

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[14] Plaintiffs do not argue the wisdom of any of the suballocated programs. They only challenge assessing insurers for the costs of such programs via Section 332.

The suballocated programs fall outside the scope of Section 332 because they divert funds to other agencies for expenses that have nothing to do with the SID's incurred costs of regulating insurers. For example, until the creation of the DFS, the SID made a suballocation to the Banking Department for the Holocaust Claims Processing Office ("HCPO"), which, among other things, assists persons to recover monies never paid in connection with insurance policies issued by European insurers.

HCPO is a blatant abuse of the insurance assessment. Not only do the HCPO's efforts relate to insurers outside the United States, but its efforts are not even focused on citizens of the State of New York. In its January 15, 2009 annual report, the HCPO noted that from its inception it has assisted with insurance claims made by individuals from 42 states and 24 countries. Thus, this cannot be an appropriate expense for Plaintiff insurers, even under Defendants' self-serving definition.[15] While the HCPO has a laudable mission, it clearly has no connection to the regulation of insurers in the State of New York or the expenses of the SID.

Similarly, the suballocations to the Department of Health have no relationship to the regulation of insurers and provide no support to the operation of the SID. For example, one of the suballocations to the Department of Health is for the forge-proof pharmaceutical prescription program, which endeavors to reduce the amount of fraudulent prescriptions written for controlled substances. The majority of the costs of this program are attributable to the printing of special prescription forms required by the Department of Health. These printing costs exceeded $13 million in fiscal year 2009-2010. (*See* Sherrin Aff. ¶56.) This program offers no benefits whatsoever to the SID's regulation of insurers, particularly Plaintiff property and casualty insurers, and is instead a regulation on physicians.

In addition to the suballocations being outside the scope of appropriate assessable costs, the

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[15] Further evidence of the Defendant's abuse of the assessment within the HCPO is that the office's annual reports identify the majority of insurance claims it assisted individuals with were with the International Commission on Holocaust Era Insurance Claims, which officially closed on March 30, 2007. Despite this closure, the HCPO maintained its nine full-time staff and the suballocations of $465,000 per year assessed to domestic insurers under Insurance Law § 332 have continued.

inclusion of some of the programs in the assessment actually defeats the purpose of the programs .For example, the Defendants have also claimed the suballocations for the Healthy New York Program and one of that program's components, the Health Maintenance Organization Direct Pay Market Program, as part of the SID's direct costs. In addition, the Pilot Program for Entertainment Industry Employees is claimed as a direct cost. These three programs subsidize insurers in order to offer lower premiums to certain classes of people. The Pilot Program for Entertainment Industry Employees serves to subsidize COBRA health insurance premiums for unemployed members of the entertainment industry. (LaBate Aff. ¶26.) Healthy NY subsidizes the insurance premium payments made by New York small business owners and low income New York State residents in order to lower their health insurance costs (*See* LaBate Aff. ¶ 21). The HMO Direct Pay program and Health Maintenance Organizations ("HMOs") offsets claims made by qualified insureds for the costs of health services. LaBate Aff. ¶ 22.) Although Healthy NY and HMO Direct Pay have existed since 2001, they only started to be funded by the Section 332 assessment in fiscal year 2008-2009, when the Division of Budget decided to shift the costs of the program to the SID under the Deficit Reduction Plan ("DRP"), described in pages 8-10, *supra.* Prior to that point, these programs were funded by Hospital assessments and cigarette taxes collected under the Health Care Reform Act, enacted in 2000. The Pilot Program for Entertainment Industry Employees was also shifted to SID as part of the DRP.

The effect of the shift of these programs to the Section 332 assessment creates an absurd result: the funds meant to subsidize insurers so they may keep their health insurance rates low are now paid directly by the insurers, including property and casualty insurers like the Plaintiffs. In essence, the insurers subject to the Section 332 assessments are subsidizing their own rates!

2. Deficit Reduction Plan, Off-Loads and General Fund Sweeps

The programs off-loaded to the assessment via the DRP and the Defendants' execution of

general fund sweeps, actions both described on pages 8-12, *supra*, are major examples of the type of abuse that disqualifies large portions of the Section 332 assessments. The DRP illegally shifted hundreds of millions of dollars from the Section 332 assessments for the sole purpose of relieving other General Fund obligations.

The press release announcing the DRP detailed a number of cost-cutting measures, a major piece of which was cutting costs in healthcare by shifting the funding for the HMO Direct Pay program and Healthy New York program from HCRA to the insurance assessment. (*See* pp. 8-9, *supra*; Nardolillo Aff. Ex. M, Bates No. 3903). There was no mention that the programs were shifted because they constituted the direct or indirect operating costs of the SID; it was simply a convenient way to reduce the budget gap by using Section 332 as a slush fund. One internal chart produced by Defendants reported the savings created by shifting the Department of Health's Cervical Cancer program to the insurance assessment through the end of 2012-13. (*See* Nardolillo Aff. ¶32 Ex. DD, Bates No. 3976.) Various other documents tout the deliberate shift from other funding sources to the insurance department. A spreadsheet entitled "2008-09 Health Care Savings Proposals – Enacted Budget" (*see* Nardolillo Aff. ¶33 Ex. EE, Bates No. 3799) listed various cost shifts such as "Shift Newborn Screening Program From HCRA To Insurance Industry Assessment" for savings of $12 million (Nardolillo Aff. Ex. EE, Bates No. 3799.) There was also a line item entitled "Finance through Ins. Assessment (i.e., Cervical Cancer, Immunization, Lead Poisoning, Childhood Obesity)" for savings of $25 million (Nardolillo Aff. Ex. EE, Bates No. 3799). An e-mail to Division of Budget department heads (*see* Nardolillo Aff. ¶34 Ex. FF, Bates Nos. 3946 to 3949) made it clear that the "increase insurance assessment for public health programs," designed to save $399.5 million in fiscal year 2009-2010 and $221 million fiscal year 2010-2011 (Nardolillo Aff. Ex. FF, Bates No. 3949), was a "revenue action" (Nardolillo Aff. Ex. FF, Bates No. 3946.) There is no mention that these programs are shifted because they meet Section 332 requirements. The shifting of health care program costs to the insurance

assessment was also described in the fiscal year 2009-2010 "Budget Briefing Book" " (Nardolillo Aff. ¶35 Ex. GG):

> ***Targeted assessments*** on the Insurance industry are recommended to reflect ***the need to receive contributions from each sector of the state's healthcare system for gap closing purposes.*** These actions will reduce spending by $855.3 million in 2009-10 and $827.0 million in 2010-11.

(Nardolillo Aff., Ex. GG, p. 42 (emphasis supplied).) These gap closing actions were also labeled as "Revenue Actions." (Nardolillo Aff., Ex. GG, p. 119.) Aside from the fact that Plaintiffs, as property and casualty insurers, are not part of the healthcare system, a proper regulatory assessment is not defined by "the need to receive contributions from each sector of the state's healthcare system for gap closing purposes."

The massive sweeps of unused Section 332 funds into the General Fund underscore that they were not needed for the regulation of insurers, but were taxes for the general welfare. Tens of millions of dollars collected for the specific purpose of the suballocated programs, not for the operating costs of SID, were never spent on those programs and were simply diverted by Defendants to cover budget gaps created elsewhere. The State Comptroller took a dim view of the use of such offloads and sweeps in an April 2010 report entitled "New York's Deficit Shuffle." (Nardolillo Aff. Ex. N ("Deficit Shuffle").). In that report, the Comptroller slammed these tools as "fiscal manipulations" and a "fiscal shell game" used to smooth over and "mask General Fund spending growth," and thereby presenting "a distorted view of the State's finances." (Deficit Shuffle, p. 1.)

The Comptroller took particular exception to the use of targeted sweeps of assessment funds from special revenue accounts, such as the Insurance Department 339-B6[16] fund, to the State's General Fund:

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[16] The 339-B6 is the number assigned to sole account in which the assessment funds are kept.

> An increase in the number of dedicated funds over the past 25 years has allowed New York's policymakers to avoid making tough decisions by instead using dubious budget tactics. New York employs a bag of fiscal tricks that move money from fund to fund, shift spending from one deficient fund to another with excess revenue and loan money "temporarily" in perpetuity to cover cash shortfalls. The net result of this dizzying array of transactions is that the true extent of the State's fiscal distress is masked and commitments made to New Yorkers are broken as their "dedicated" tax and fee payments are used for other purposes.

(Deficit Shuffle, p. 2.)

3. Abuse and Double-Dipping in Programs

The State's practices here are similar to their illegal conversion of a Department of Health special revenue account, funded by fees charged to clinical laboratories, which was turned into an "unauthorized and unsupervised revenue stream that is limited only by the bounds of defendants' creativity." *AAB II* Decision and Order, p. 26. In the instant matter, the Defendants have created an analogous limitless and improper revenue stream, as further demonstrated by instances of double dipping.

Documents produced by Defendants and responses to interrogatories demonstrated that the Attorney General's Office Auto Insurance Fraud Unit ("AIFU"), claimed as an indirect cost by Defendants, billed insurers for personal service positions that remained vacant and even billed insurers for salaries of individuals who worked full time for other bureaus or units. In response to Plaintiffs' First Set of Document Demands, the Defendants made a partial production of the AIFU's budget requests for the relevant fiscal years. (*See* Nardolillo Aff. ¶36 Ex. HH, Bates Nos. 1609-1617.) These documents detail the personnel costs requested by the AIFU, by listing salary costs by item number, and the name of the individuals who filled those positions. (Nardolillo Aff., Ex. HH, Bates No.1610.) The salary costs include assumptions that each employee qualifies for performance pay and contractual salary increases. As is clear from these documents, in some years for which they were funded, the positions were actually vacant. (Nardolillo Aff., Ex. HH, Bates Nos.1610, 1612, 1614, 1615, and 1617; *see also*

Nardolillo Aff. ¶37 Ex. II ("Def. Resp. to Fourth Set of Interrogatories.")).[17]

Also egregious was the use of the insurance assessment to finance investigative positions for individuals who did not even work in the AIFU. From fiscal year 2008-2009 through 2010-2011, no fewer than four positions per year were financed by the insurance assessed for individuals who worked full-time in other departments or split time with other units. See Def. Resp. to Fourth Set of Interrogatories, Response 1(d); See also item numbers 9321, 9322, 9326, 9334, 9335.

Most shocking, however, is the revelation of blatant "double-dipping"- that is charging the cost of a program to the Section 332 assessment while also drawing from other income sources to cover the same costs. This has been found specifically in the Newborn Screening Program run by the Department of Health.

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[17] For example, in response to the Plaintiffs' Fourth Set of Interrogatories, which asked the Defendants to identify "each individual assigned to the Auto Insurance Fraud Unit in each budget year," the Defendants produced a chart entitled "Items Charged to AIFU Funding, FY2008-2009 thru FY2010-2011." (*See* Nardolillo Aff, Ex. II, Def. Resp. to Fourth Set of Interrogatories, Exhibit A.) This chart reveals that certain item numbers which appeared in the budget requests were never filled. For example, in their 2009-2010 budget request, the AIFU requested a total salary of $109,741 for Item Number 9309, which was to be filled by Assistant Attorney General Nina Sas. *See* Nardolillo Aff., Ex. HH, Bates No. 1615. However, Defendants' chart of items charged to the unit's funding reveal that Item Number 9309 was not filled in FY2009-2010, and was not even filled in the prior fiscal year of FY2008-2009. (*See* Def. Resp. to Fourth Set of Interrogatories, Exhibit A.) This is noteworthy because the FY2009-2010 budget request for Item Number 9309 operated with an assumption of a prior year's base salary of $106,283, even though the Defendants' response to the interrogatories demonstrates that the costs attributable to this item number were charged and collected. However, the position that corresponded to that item number was not filled by anyone. (*See* Def. Resp. to Fourth Set of Interrogatories, Exhibit A.) This practice was repeated in the budget request for FY2010-2011; the line for Item Number 9309 requested a total salary of $109,309 based upon an August 2009 salary level of $103,187 (*see* Nardolillo Aff., Ex. HH, Bates No. 1617), even though the State Defendants' interrogatory response shows that Item Number 9309 was not filled in the 2009-2010 budget year.

This practice of requesting funds for positions that were never filled was repeated with other item numbers. In its FY 2009-2010 budget request, the AIFU requested $56,898 for a "Tech Rep" position that was listed as "vacant." (*See* Nardolillo Aff., Ex. HH, Bates No. 1615.) However the Defendants' response to the fourth set of interrogatories demonstrates that the vacant position that was billed to the assessment for item number 09352 was not filled in FY 2009-2010. Its budget request for fiscal year 2009-2010, the AIFU requested funding for a salary of $68,206 for item number 9313 to be filled by Assistant Attorney General Martha Vasquez. However defendants did not fill that position in fiscal year 2009-2010, despite its being charged to the AIFU funding. This item number was again charged to AIFU funding in FY2010-2011 despite the fact that this positions also remained vacant in FY 2010-2011 and had also appeared in the FY 2010-2011 budget request at a total salary level of $100,410.

The Defendant is also charged positions for investigators, auditors, and support staff that were never filled (*See* item number 9327, Nardolillo Aff., Ex. HH, Bates No.1615, 1617; compare Def. Resp. to Fourth Set of Interrogatories Ex. A; *See also* item numbers 9341, 9346).

Discovery and trial testimony in two cases, *AAB II* and *AAB III* involving the Department of Health's clinical laboratory reference system special revenue fund, revealed that the costs of the Newborn Screening Program were being charged twice: once to insurers through Section 332 and once to clinical laboratories subject to a Department of Health assessment. This situation is fully detailed in the attached November 22, 2013 Affirmation of Jeffrey J. Sherrin, the attorney in those cases, with accompanying exhibits. For example, documents produced in the instant matter, when compared with discovery in *AAB II* and *AAB III*, reveal that the Section 332 insurers were being charged for the full salaries of numerous employees involved in the Newborn Screening Program at the same time the clinical laboratories were being charged for the same positions.

4. The Costs of Suballocated Programs are Actually the Direct and Indirect Costs of the Agencies Which Receive the Suballocated Funds, Not the Costs of the SID

a. *Aside from the fact that the challenged suballocations are not operating expenses of the SID's regulatory function, these programs are not within the scope of Section 332 because they are not carried as the direct or indirect costs of SID. Rather, the programs are the direct and indirect costs of the agencies receiving the suballocations. Department of Health Budget Director Testifies That Those Programs Are Actually Direct and Indirect Costs of the Department of Health*

Mr. Cahill testified that that the expenses associated with the suballocations to the Department of Health for various programs were not the direct or indirect costs of the Insurance Department, but were the direct and the indirect costs of the Department of Health, and thus not assessable under Section 332. These programs include (1) the Center for Community Health program ($14.6 M in FY 2010-11), which provides funding to local agencies for a variety of public health issues; (2) the DOH's hospital reimbursement rate setting duties ($365K in FY 2010-11); (3) Office of Managed Care: Certification Activities ($300K in FY 2010-11), which oversees certification activities for new and

existing managed care organizations, investigates complaints, and monitors both commercial and Medicaid plans; (4) Office of Managed Care: Implementation Activities ($300K in FY 2010-11), which support information systems management capabilities for Office of Managed Care staff, Managed Care Organizations, and counties for the Medicaid managed care waiver; (6) Forge Proof Prescription ($16.4 M 2010-11) to prevent illegal diversion of prescription controlled substances; and (7) Newborn Screening program ($11.9 M in FY 2010-11) through the Wadsworth Center, which conducts mandated newborn screening tests for certain neonatal conditions. (*See* Nardolillo Aff. ¶38 Ex. JJ, Bates Nos. 7803-7804.)

All of these programs are fully administered by DOH and Mr. Cahill testified that, under State accounting rules, the costs of these programs are actually the direct and indirect costs of DOH and are carried and reported as such. They are not the direct or indirect costs of the SID. Mr. Cahill testified that the salaries of the employees assigned to the newborn screening program, the fringe benefits and the other than personal service costs associated with those state employees are the direct costs of the DOH (Cahill Dep. 39:1-18). Mr. Cahill also testified that the indirect costs attributable to the Newborn Screening program are the indirect costs of the DOH (Cahill Dep. 39: 19-22), and because the costs of the Newborn Screening program were the direct and indirect costs of DOH, they were not the direct and indirect costs of SID (See Cahill Dep. 39:23 through 40:23). In fact, when Mr. Cahill was asked whether his answer—that the direct and indirect costs of the suballocated Newborn Screening program were the direct and indirect costs of DOH and not SID—would apply for all of the other suballocated programs of the Department of Health, Mr. Cahill responded that his answer would be the same (Cahill Dep. 41:10-18), confirming that the personal service costs, the indirect costs, and the other than personal service ("OTPS") costs for each of the programs suballocated to DOH would be the direct or indirect costs of DOH and not SID (Cahill Dep. 41:19-42:3). This is further demonstrated by documents from the DOH, such as its expenditure reports (*See*, e.g., Nardolillo Aff. ¶39 Ex. KK, Bates

Nos. 522-523; Fraser Dep. 116-117). Circular A-87 provides that "[a] cost may not be allocated to a Federal award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to a Federal award as a direct cost." 2 C.F.R. § 225 App. E (Circular A-87, p. 51924).

Another significant fact is that the insurance assessment does not provide the sole source of funding for some of the challenged programs. If the suballocated programs were indeed the direct or indirect operating expenses of the SID, the full cost of the program would be chargeable to the Section 332 assessment.

For example, the Division of Managed Care and Program Evaluation within DOH received suballocated funds for the costs of the "certification of managed care plans," and the "implementation of systems to monitor the performance of managed care plans." However, neither program was fully funded by the Section 332 assessment. An e-mail from William L. Lawton (*see* Nardolillo Aff. ¶40 Ex. LL, Bates No. 3961), dated March 10, 2009, revealed that the money received through the insurance assessment for the implementation plan was roughly 21.6% of the full funding for the project. The expenditure plan for the program makes it clear that "[t]his suballocation is used to fund a ***portion*** of the staff costs related to the collection and public dissemination of health plan quality data and to analyze provider network data and financial data." (Nardolillo Aff. Ex. LL, Bates No. 3972.) The same is true of the certification plan, which attributed only about 16.5% of the full funding to the Section 332 assessment (Nardolillo Aff. Ex. LL, Bates No. 3961.) Again the expenditure plan for that program reveals that the suballocation only "funds a portion of the staff costs related to the certification and surveillance of managed care plans." (Nardolillo Aff., Ex. LL, Bates No. 3968.) Those suballocated funds from Section 332 only comprise a fraction of the full funding received for these programs confirms that these programs cannot fall within Section 332.

b. *The Insurance Department Has No Control Over the Programs, Their Budgets, and Their Expenditures*

Also evidencing that the suballocations are not the direct or indirect operating costs of SID is that the SID has absolutely no input, let alone control, over the programs. The Division of Budget unilaterally dictated what programs were to be included in the Section 332 assessment. Once the budget was enacted, the SID had no oversight of those funds or how they were expended.

Budget requests are submitted by the target agencies to DOB. Normally, the direct costs of the suballocated programs, such as personal service (*i.e.*, salary) costs, would not appear in the personal service recap of the SID's budget request (Fraser Dep. 23), but would be found instead in the budget requests for the target agencies (Fraser Dep. 23-24). Therefore, the personal service costs for the suballocated programs would not be identified as direct costs of the SID (*see* Fraser Dep. 73:14 – 17; 73:23 – 24).

If the suballocated program was new, the SID might not find out about the program until it received its approved budget from the DOB. In any event, SID would not know about the program's inclusion in its own budget until it would receive word from the DOB that it was to be included (Fraser Dep. 53-54). It was clear that the ultimate authority of what was to be included in the budget would rest with DOB. For example, in 2007-2008, SID senior managers instructed staff that the suballocated programs were not to be included in the SID's final budget. However, DOB officials overrode that decision and ordered SID to include the programs (Fraser Dep. 59-61, 62).

Notably, expenses of SID-controlled funds, *i.e.*, non-suballocations, were subject to a specific SID internal approval process. (*See* Fraser Dep. 64-66.) In contrast, the SID has no role when there is a request for an expenditure within a suballocated program, because SID was not involved in that. (*See* Fraser Dep. 66:23 through 67:6.) The purchase request under that program would be generated in another agency, in this case the Department of Health. (*See* Fraser Dep. 67:7 – 14.) Ms. Fraser confirmed

that with respect to any purchase request emanating from a suballocated program, no one within the SID reviews and approves or disapproves of that expenditure. (*See* Fraser Dep. 67:21 through 68:2.)

The non-involvement of SID in the expenditures of the suballocated programs is also true with regard to the programs identified in the budgets under "aid to localities." First, these programs have been confirmed to be outside of the scope of the definition of "operating expenses." (*See* pp. 17-18, *supra.*) As described above, "aid to localities" represents funding to support local government programs. *See* p. 18, *supra.*) Included under the aid to localities category are programs such as the Healthy New York program, the HMO Direct Pay Program, and the Centers for Community Health. (*See e.g.* 2009-2010 SID Budget (Nardolillo Aff. ¶41 Ex. MM, pp. 305-306).

The costs of the programs within the aid to localities category, such as employees' positions and salary, are not carried or recorded as direct costs of the SID (Fraser Dep. 87:11-17.) Also, because the local government units are not state agencies, let alone CSSAs, none of the costs of the local government units receiving aid to localities funding are encompassed within the calculation of the indirect cost rate for SID found in the Statewide Cost Allocation Plan. (Fraser Dep. 88).

The local government entities themselves actually spend the money that is allocated to them through the aid to localities programs. (Fraser Dep. 93:20-24.) Using the cervical cancer vaccine program as an example, the localities do not have to present any expenditures to the SID for review or approval before making expenditures (Fraser Dep. 94:5-7), meaning that the Insurance Department essentially has no say in how the cervical cancer vaccine funds actually get spent by local government units. (Fraser 94:8-14.)

5. The Suballocations Claimed as Indirect Costs Are in Conflict with the Indirect Cost Rate Reported in the Statewide Cost Allocation Plan

Another demonstration that the suballocated programs are not the indirect costs of the Insurance Department is that the indirect cost rate of the suballocated programs is at odds with the

indirect cost rates calculated by the Division of Budget under the Statewide Cost Allocation Plan ("SCAP"). The indirect costs charged to SID through the SCAP are already included in the Section 332 assessment and paid by Plaintiffs.

As described above on pages 19-20 *supra*, the State prepares the SCAP, in line with Circular A-87, to allocate the indirect costs, building depreciation, equipment use charges, employee fringe benefits, civil service costs, and payment in lieu of taxes incurred by the CSSAs to the line agencies. What the SCAP demonstrates is that the indirect costs actually charged to SID are a fraction of the costs claimed as direct and indirect costs through the insurance assessment. Taking the 2009 SCAP (*see* Nardolillo Aff. Ex. T) as an example, the total indirect costs projected for SID were $1,934,740. (Nardolillo Aff. Ex. T, Bates No. 17313). That same SCAP noted that the actual costs allocated to SID for the fiscal year 2007 were just $1,748,127. (Nardolillo Aff. Ex. T, Bates No. 17336.) Notably, the total amount of costs allocated under the ***entire*** SCAP totaled $600,239,591 for fiscal year 2007, (Nardolillo Aff. Ex. T, Bates No. 17337), and the total costs for fiscal year 2009 in the SCAP, ***for all of the 12 central service agencies covered in the report,*** were just $425,128,791.

When these costs are compared with astronomical the costs claimed by the Defendants to be the SID's indirect costs, it becomes clear that Defendants are not truly applying the concept of indirect costs, but rather are seizing upon that term to try to explain the slush fund they have created. Thus, in fiscal year 2008-2009, the total amount of the Section 332 assessment was $443,075,600, which is more than the total indirect costs for all state agencies reported in the statewide cost allocation plan. (*See* Daigneault Aff. ¶24), of which $111,504,000 were claimed as the indirect costs of the SID. (*See* 2008-2009 Budget (Nardolillo Aff. Ex. L); LaBate Aff. ¶¶27-51 (describing programs included as SID indirect costs).)

Moreover, the Plaintiffs already pay the indirect costs of the SID as charged by the SCAP. For example, in the budget for fiscal year 2008-2009, the SID's allocations for its regulation program

(Nardolillo Aff. Ex. L p. 365:12 – 28), administration program (Nardolillo Aff. Ex. L p. 363:20 – 39), and its consumer services program (Nardolillo Aff. Ex. L p. 364:1 – 22) all explicitly contained a line item for indirect costs under the category of nonpersonal costs.

6. SID Does Not Report the Suballocated Programs in the Budget It Submits to Its National Accreditation Association

Further proof that the suballocated programs are not properly within the Section 332 assessment is found within the budget that SID submitted to its national accreditation association. That submission did not include any of the suballocated programs, confirming that these costs are outside the scope of Section 332.

The SID is a member of the National Association of Insurance Commissioners ("NAIC"). In order to be an accredited member, the SID must go through a comprehensive accreditation process every five years, and the most recent NAIC review was completed in 2009. According to the SID's own budget request submitted to the Division of Budget, "The NAIC accreditation program emphasizes adequate solvency laws and regulations, efficient and effective financial analysis, examination processes and communication, and appropriate organization and personnel practices." (*See* Nardolillo Aff. ¶42 Ex. NN, Bates No. 349). According to the SID, the NAIC requires their accredited members to undergo independent audits once every five years to ensure that members "have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs, and that they have the necessary resources to carry out that authority." (*See* Nardolillo Aff. Ex. NN, Bates No. 349)

As part of its membership in the NAIC, the SID participates in an annual survey, conducted by the NAIC, in which it reports its budget levels. This survey, which is conducted of all 50 states' insurance departments, results in a report put out by the NAIC entitled the "Insurance Department Resources Report." (*See* Nardolillo Aff. ¶43 Ex. OO.) In the 2012 report it was revealed that the SID has been reporting total budget amounts that are far below the amounts that it seeks every year through

the Section 332 assessment. For example, according to information voluntarily provided to NAIC, the SID reported its 2013 insurance budget as just $143,593,860 in 2013. Between 2009 and 2013, according to this report, New York's insurance budget ranged from a high of $149,038,000 in 2009 to a low of $139,851,000 in 2010. (*See* Nardolillo Aff. Ex. OO.)

This is clearly far below what the SID has charged to insurance companies over this period through the Section 332 assessment, even though the SID affirmed that it had based the assessments upon the "Department's expenses, both direct and indirect costs, as appropriated ***in the enacted budget.***" (Daigneault Aff. ¶15.) The NAIC report confirms that the SID views its own budget as not including the suballocated programs and that the suballocations do not represent their operating expenses, direct costs, or indirect costs.

E. The Defendants' Purported Definition of Direct and Indirect Costs Should Be Rejected

To justify the inclusion of the challenged suballocations in the Section 332 assessment, the Defendants claimed in their prior summary judgment motion that the programs are proper direct and indirect costs of SID because they "relate to the conduct of insurance business, the regulatory concerns of the Department, and the administration of the Department." (*See* LaBate Aff. ¶¶ 3, 4; Daigneault Aff. ¶ 14.) Specifically, the Defendants attempted to justify the appropriations for the Healthy New York Program, the Health Maintenance Organization Direct Pay Market Program, and the Pilot Program for Entertainment Industry Employees as SID's direct costs because these are programs purportedly to "provide New Yorkers with affordable insurance coverage, which is one of the Department's most important functions." (*See* LaBate Aff. ¶¶ 18, 26).

The remaining programs are claimed by Defendants as appropriate "indirect costs" because these suballocations "relate to the conduct of insurance business and the regulatory concerns of the Department," and "fund programs which further the Department's functions of, *inter alia,* ensuring the

fair treatment of insurance policyholders and claimants, regulating insurance companies and rates, keeping insurance available and affordable for all consumers in New York, keeping the costs of such insurance coverage down, diminishing the occurrence and magnitude of claims filed against insurers, and addressing costs resulting from the filing of false and fraudulent claims." (LaBate Aff. ¶27.)

The Court should reject the Defendants' litigation-created definitions for several reasons. First, these justifications and broad definitions on direct and indirect costs are completely fabricated. These purported standards of appropriate direct costs and indirect costs described in Ms. LaBate's Affidavit were actually created by the Attorney General (*See* LaBate Dep. 60:10-15) to justify the costs in this litigation. They were never used in the normal course of business. Courts give little, if any weight to definitions created for litigation purposes. See *American Ass'n of Bioanalysts v. New York State Dep't of Health* ("*AAB II*") 75 A.D.3d 939 (2d Dep't 2010) (affirming trial court rejection of definition prepare in response to litigation)

Furthermore, the purported definition of indirect costs as costs that "relate to the conduct of insurance business and the regulatory concerns of the department," did not exist anywhere in writing other than that affidavit. (LaBate Dep. 113:13-114:3-6.) Likewise, no written definition of what constituted the "regulatory concerns" of the SID or what related to the conduct of the insurance business exists. (See LaBate Dep. 114:3 to 115:4.) Ms. LaBate could not point to any written guidance as to which activities would fall within the scope of "relating to the conduct or the regulatory concerns" of the SID, instead erroneously suggesting that the language of Section 332 would define the "overall focus of the State's goals in regulating the insurance industry" (See LaBate Dep. 116:16-21).

However, Section 332, as demonstrated above, does not authorize charging domestic insurers for any cost that "relates to the regulatory concerns" of the Department; it allows for the recovery of the direct and indirect operating expenses of the Department. The Court should also reject the "relate to" standard because it has been recently rejected in a similar case in which New York State attempted to

use that broad language to defend assessments upon clinical laboratories. At issue in that litigation was a statute which directed DOH, through the Wadsworth Center, to inspect clinical laboratories licensed by the State and to review their testing methods for proficiency. This statute allowed the DOH to assess the costs of regulating these clinical labs, and required DOH to adopt rules and regulations "establish[ing] schedules of inspection and laboratory reference fees in amounts not exceeding the estimated cost of the program and subject to the approval of the director of the budget". N.Y. Pub. Health Law § 576 (4); *see also American Ass'n of Bioanalysts v. Axelrod*, 106 A.D.2d 53, 55 (3d Dep't 1985) ("*AAB I*").

Litigation regarding the laboratory inspection and reference program ensued after it was suspected that the Wadsworth Center was increasing the assessments to pay for costs that were not necessary for laboratory regulation. In the first lawsuit, plaintiffs—a group of clinical laboratories and a national association of these entities—challenged the assessment as unconstitutional on its face because the assessed fees were, as they are here, far in excess of what was necessary for regulating laboratories, and were used to pay for expenditures outside the regulatory program. The *AAB* Plaintiffs, as here, argued that the excessive fees converted the regulatory assessment into an illegal tax.

What saved the facial constitutionality of section 576(4) when it was previously litigated was the finding that the purpose of the statute was just "to recover the cost of regulating clinical laboratories, not to raise revenue for the support of government generally." *AAB I*, 106 A.D.2d at 56. Despite that finding, DOH continued to knowingly and openly violate this principle, purposefully using the inspection and reference program special revenue funds to support general state operations.

This spurred a renewed lawsuit in which the plaintiffs, among other claims, alleged that the ***implementation*** of the statute constituted an illegal tax. When the DOH moved to dismiss this complaint, the court cited to the 1985 Third Department decision in *AAB I*, noting that "significantly, the Court held that '[t]he purpose of the subject statute is to recover the cost of regulating clinical

laboratories, not to raise revenue for the support of government generally.'" (*See* Nardolillo Aff. ¶44 Ex. PP, p.3, n.1). Further, the court upheld Plaintiffs' first and second causes of action relating to the implementation of the statute as an illegal tax (*See* Nardolillo Aff. Ex. PP, p. 12):

> In view of the holding in *Assn. of Bioanalysts v. Axelrod, supra*, and given plaintiffs' allegations that cooperative research with the regulated laboratories is neither a function of the clinical laboratory evaluation program, nor is it a cost of regulation of clinical laboratories, plaintiffs' first and second cause of action sufficiently state causes of action. Accordingly, defendants' motion to dismiss plaintiffs' first and second causes of action is denied.

That principle was recognized throughout the history of that litigation, where the courts consistently held that the Department may recover no more than its actual costs of regulating the laboratories. This litigation was next before the Appellate Division, Third Department, in November 2004, on Defendants' appeal from an order compelling answers to interrogatories. There, the Third Department expressly restated its past holding that the statute was constitutional because its purpose was "to recover the cost of regulating clinical laboratories." *American Association of Bioanalysts v. New York State Department of Health*, 12 A.D.3d 868, 869 n.1 (3d Dep't 2004) ("*AAB II*"). Ruling on the cross-motions for summary judgment, Justice Tomlinson repeated the same principle and held that no subsequent statutory changes to PHL § 576 "have broadened the scope of the use of the fees to include general governmental expenses" (*See* Nardolillo Aff. ¶45 Ex.QQ, p. 4). Upon appeal, the Appellate Division, Third Department, stated that the costs properly charged to clinical laboratories are the direct and indirect costs "necessarily incurred" in support of the program. *American Association of Bioanalysts v. New York State Department of Health*, 2006 N.Y. Slip Op. 7648, 33 A.D.3d 1138, 1140 (2006). The Appellate Division, addressing the issue of indirect costs, reinforced this standard, holding that actual costs "properly include both direct and indirect costs necessarily incurred in support of the program." *Id.* at 1139.

The reasonable and necessary standard finds its basis not just in the most recent Appellate

Division decision, but as well in Federal Circular A87, which the Department is committed to comply with in the determination and allocation of costs. (*See* Circular A-87 p. 51912, which states that to be allowable, costs must be "necessary and reasonable for proper and efficient performance and administration of Federal awards.") Thus, in order to be chargeable to laboratories, the costs must not only be costs that are part of the system of periodic testing of laboratory methods, procedures and materials, but they must be reasonable, and necessary for the efficient regulation of laboratories.

At trial, employing a standard eerily similar to that advanced by Defendants here, the Wadsworth Center Director testified that, in his view, "all of the Wadsworth Center's research is includable as a cost of the program as long as it somehow relates to standards or development of laboratory methods without regard to whether such methods are ever used by the clinical laboratories." *AAB II*, 75 A.D.3d 939, 944 (3d Dep't 2010.) And as here, the "related to" standard was first conceived in response to the litigation. *Id.* As such these costs were disallowed after trial, a decision that was affirmed upon appeal. *Id.*

The court's rejection of the "relates to" standard, even aside from the law of the case defining the scope of the assessable reference program costs, was well-founded in Supreme Court case law. *New York State Conf. of Blue Cross and Blue Shield Plans v. Travelers*, 514 U.S. 645, 655 (1995), concerned an ERISA preemption statute that expressly applies against all state laws that "relate to any employee benefit plan." The U.S. Supreme Court nevertheless found against preemption, stating that "one might be excused for wondering, at first blush, whether the words of limitations ('insofar as they ... relate') do much limiting. If 'relate to' were taken to extend to the furthest stretch of its indeterminancy, then for all practical purposes preemption would never run its course, for really, universally, relations stop nowhere." In words seemingly prophetic with respect to the instant litigation, the High Court in *Travelers* recognized that reading the term "relate to" expansively would read Congress' words of limitation "as mere sham." *Id.* Rather, the Court held that it "must go beyond the unhelpful text" and

look instead to the statutory objectives. *Id.* at 656.

In the instant matter, the limitless nature of Defendants' justifications for the direct and indirect costs was demonstrated through Ms. LaBate's deposition testimony in which she was asked to define what "related to" the regulatory concerns of the SID. She testified that one such category included programs which helped reduce the likelihood of insurance claims. (LaBate Dep. 116:22 to 117:4). However she could not name five activities that the State of New York is engaged in that do not have some potential impact on the likelihood of claims. (LaBate Dep. 117:5 to 117:18). When pressed for a definition as to what programs that impact the likelihood of claims are included, and which are not, Ms. LaBate was presented with an example which demonstrated just how arbitrary the suballocation process was.

> Q. How about how everybody drives cars and how cars are built and maintained, would that create a likelihood or affect the claims that are filed against insurance companies?
>
> MR. LOMBARDO: I object to the form of the question.
>
> A. It could potentially
>
> MR. LOMBARDO: What the State of New York does? You mean inspecting cars?
>
> Q. Does the State regulate in some way how cars are inspected, how they're operated, how they're maintained –
>
> A. Right. But—
>
> Q. -- how garages and service -- let me finish. How garages and service stations are licensed and how they operate? Doesn't the State control all those, or regulate all those activities?
>
> A. Yes.
>
> Q. And in the regulation of those activities, doesn't that affect the likelihood of claims being made for personal injury or property damage from auto accidents?
>
> A. Yes.

Q. And is there some reason why those expenses for all those activities are not suballocated to the Insurance Department? Because they would seem to relate in some way?

. . .

A. In my involvement with this, there's never been a suggestion or an attempt to be all inclusive on any program or any facet of State operations that could have an impact on the insurance industry.

Q. So somebody is picking some items that could have an impact and saying we are going to suballocate those to the Insurance Department and we are not going to suballocate others; right?

A. Correct.

(Labate Dep. 118:2 to 119:21.)

Significantly, Defendants should be precluded from even making this argument, since they claimed a privilege in depositions over deliberations which determined what programs could be included (LaBate Dep. 120:20 to 121:19) and discussions over the definition of direct and indirect costs included in her affidavit (*see* LaBate Dep. 62:5 through 63:10) and reiterated this privilege when Plaintiffs submitted follow-up interrogatories seeking information about the conversations and deliberations referenced by Ms. LaBate (*see* Nardolillo Aff. ¶46 Ex. RR). Courts have routinely precluded the later use of information at trial that had been shielded from opposing parties during discovery. *See*, e.g., *Collins v. Troy Pub. Co. Inc.*, 213 A.D.2d 879, 880-881 (3d Dep't 1995) (upholding protective order precluding newspaper from relying on sources at trial if newspaper chose to keep sources confidential under shield law); *Yetman v. St. Charles Hosp.*, 112 A.D.2d 297, 298 (3d Dep't 1985) (holding "[w]here the privilege has not been waived," the remedy "is to preclude . . . evidence concerning matters as to which the privilege has been asserted"); *Greenberg v. CBS Inc.*, 69 A.D.2d 693, 709 (2d Dep't 1979) ("At trial, if the defendants opt to rely on their statutory privilege [to protect sources], they should be precluded from any use of those sources and information . . . ").

Even the SID acknowledges that the suballocated programs are outside of the SID's true mission. In its 2010-2011 budget request, the SID conducted a number of reappropriations for the suballocated programs (*see* Nardolillo Aff. Ex. NN, Bates No. 363). In its 2010-2011 budget request, the SID sought over $6,000,000 in reappropriations for unspent funds for the suballocations. (Nardolillo Aff., Ex. NN, Bates No. 363). Under the column entitled "Justification for Requested Action" these reappropriated amounts were declared to be "Unrelated to the Department's Mission." This meant that the reappropriation of the 2008 appropriation was unrelated to the SID's mission, as stated in its mission in 2010-2011 (Fraser Dep. 99:5-7 and 108:21-109:18). In summary, the costs of the suballocated programs are not operating costs, direct costs or indirect costs of the State Insurance Department, and they are not made to be such simply by funneling them on paper through the SID budget. Since these suballocated costs are not the reasonable and necessary costs of regulatory insurers, they are by definition not regulatory assessments as Defendants have previously argued. They become, as a matter of law, illegally imposed taxes.

POINT II

IN IMPOSING THE IMPROPER SUBALLOCATIONS UPON PLAINTIFFS, THE EXECUTIVE BRANCH DEFENDANTS ACTED IN EXCESS OF THEIR JURISDICTION AND COMMITTED ERRORS OF LAW

Insofar as the Superintendent of Insurance and/or the Superintendent of Financial Services elected to include the challenged suballocations into the amounts the SID assessed to Plaintiffs, and insofar as the Director of Budget elected to approve the inclusion of these programs in the insurance assessment, the state officials have acted in excess of their jurisdiction and committed errors of law.

Both the Superintendent of Insurance and the Director of Budget have particular responsibilities under Section 332. First the statute requires that the Superintendent of Insurance carry out the assessment of the operating expenses of the SID. "The expenses of the department . . . shall be assessed by the superintendent pro rata upon all domestic insurers and all licensed United States branches of alien insurers domiciled in this state." N.Y. Ins. Law § 332(a). The "expenses of the department" are "approved by the director of the budget and audited by the comptroller."

The assessments must be invalidated because they are outside the scope of assessable operating costs under Section 332. It is axiomatic that the failure to comply with a statute constitutes grounds for annulment of the action taken under the statute's purported authority. As such, the SID as an administrative agency and creature of statute, is without power to exercise any jurisdiction beyond that conferred by statute. *See Flynn v. State Ethics Comm'n,* 87 N.Y.2d 199, 202, (1995) ("since the jurisdiction of an administrative board or agency consists of the powers granted it by statute, a determination is void and subject to collateral attack where it is made either without statutory power or in excess thereof.") (quoting *Foy v. Schechter,* 1 N.Y.2d 604, 612 (1956). The fact that the challenged programs in this case may be beneficial to the public is irrelevant. "Even under the broadest and most open-ended of

statutory mandates, an administrative agency may not use its authority as a license to correct whatever societal evils it perceives." *Medical Society of the State of New York v. Serio*, 100 N.Y.2d 854, 865 (2003), *quoting Boreali v. Axelrod*, 71 N.Y.2d 1, 9 (1987). Therefore, although the SID possesses regulatory powers, it must nonetheless operate within the limits of the Insurance Law and simply "follow the statute the way it reads." *Life Ins. Co. v. Superintendent of Ins.*, 16 N.Y.2d 237, 245 (1965) (annulling penalty levied by Superintendent of Insurance because it was not supported by statute).

In this matter, the challenged assessments must be annulled because the suballocated programs do not meet the definitions of assessable costs under Section 332. For the reasons stated above, the suballocations are not the operating expenses of the SID because they are not costs incurred by the SID in regulating individuals and companies subject to the Insurance Law. The suballocations also cannot constitute the direct or indirect costs of SID. Those programs are the direct costs of other agencies, not SID. Furthermore, indirect costs are universally defined, understood and accepted as the Central Service State Agency costs, which are separately charged to all the line agencies through the Statewide Cost Allocation plan and SID's true indirect costs are already passed onto insurers through the Section 332 assessment. The suballocated programs are outside the scope of the proper definition of indirect costs, and Defendants' concocting a strained, never-before utilized definition of indirect costs for litigation purposes does not change the meaning of the term in statute.

An analogous situation is found in the jurisprudence surrounding license fees, which is exactly what a regulatory assessment is. In that arena, courts have not hesitated to strike down license fees as excessive that have been enlarged beyond the costs of issuance, recording, and enforcement of those licenses permitted by the statute. These cases stand for the proposition that regulatory fees must be limited to the particular regulatory activity for which the government seeks reimbursement. *See Adlerstein v. City of NY, Dep't of Water Supply, Gas & Elec.*, 174 N.Y.S. 2d 610 (Sup. Ct. N.Y. County 1958) *aff'd sub nom. Adlerstein v. City of New York*, 7 A.D.2d 717 (1st Dep't 1958) *aff'd*, 6 N.Y.2d 740 (1959)

(license fee upon electricians was deemed unconstitutional because it included cost of department inspections of electrical installments and had nothing to do with chargeable expenses incurred by licensing authority for issuance, recording and enforcement); *Town of North Hempstead v. Colonial Sand and Stone Co.*, Inc., 178 N.Y.S. 2d 579, 584-585 (Sup. Ct., Nassau County 1958) (permit and inspection fee upon excavators was grossly excessive of the administrative costs); *Sperling v. Valentine*, 28 N.Y.S. 2d 788, 791-792 (Sup. Ct., New York County 1941) (license fee upon food vendors was deemed unconstitutional because the cost of the Department inspections had nothing to do with the licensing statute, and therefore, the fee was in excess of the measure of the cost of licensing)).

The result should be no different here. The Superintendent and Director have respectively assessed and approved transferring direct costs of other state agencies or localities to domestic insurers, not to meet the requirements of Section 332, but because there was a fund available to tap into to the extent of their imagination. *See AAB II* Trial Decision, p. 11 (Justice Sheridan finding that similar actions by the Department of Health had "turned the clinical laboratory reference system special revenue account into an unauthorized and unsupervised revenue stream that is limited only by the bounds of defendant's creativity.") They have acted outside the authority granted to them under the law and the assessments must therefore be annulled, and the overassessed fees be returned to the Plaintiffs and the members of the Plaintiff association. *See Am. Ass'n of Bioanalysts v. Axelrod*, 130 A.D.2d 889 (3d Dep't 1987) (holding that regulatory fees declared invalid must be fully refunded to the laboratories).

POINT III

THE EXCESS FEES ARE NOT REGULATORY ASSESSMENTS, BUT RATHER TAXES

Proper regulatory fees must be "reasonably necessary to the accomplishment of the regulatory program." *Walton v. New York State Dept. of Correctional Services*, 13 N.Y.3d 475, 485 (2009) (quoting *Suffolk County Bldrs. Assn. v County of Suffolk*, 46 N.Y.2d 613, 619 (1979). Regulatory fees must also bear at least "a rough correlation to the expense to which the State is put in administering its licensing procedures or to the benefits those who make the payments receive" *Id.* (*quoting American Ins. Assn. v. Lewis*, 50 N.Y.2d 617, 622 (1980) and citing *National Cable Television Assn., Inc. v United States*, 415 US 336 (1974). "Typically, fees are paid to obtain access to a government service or benefit, such as the fees paid to obtain licenses to practice professions in particular jurisdictions." *Id.*

The difference between a legally-imposed regulatory assessment on a particular industry and an illegally-imposed tax is that the assessment is used only to recover the costs of the particular regulatory program, while a tax occurs when the funds are used to support other state objectives, rather than just the regulation of the affected industry. *See Nitkin v. Administrator of Health Services Admin.*, 91 Misc.2d 478, 479 (Sup. Ct. N.Y. County 1975), *aff'd*, 55 A.D.2d 566 (1st Dep't 1976), *aff'd*, 43 N.Y.2d 673 (1977); *Adlerstein v. City of New York*, 11 Misc.2d 754, 755 (Sup. Ct. New York City 1958), *aff'd*, 7 A.D.2d 717(1st Dep't 1958), *aff'd*, 6 N.Y.2d 740 (1959); *People v. Brooklyn Garden Apartments, Inc.*, 283 N.Y. 373 (1940); *Matter of Hanson v. Griffiths*, 204 Misc. 736, 738 (Sup. Ct. Westchester County, 1953), *aff'd*, 283 A.D. 662 (2d Dep't 1954); *People v. Strax*, 80 Misc.2d 679 (New York County Crim. Ct. 1975). "A tax is a charge that a government exacts from a citizen to defray the general costs of government unrelated to any particular benefit received by that citizen." *Walton v. New York State Dep't of Corr. Servs.*, 13 N.Y.3d 475, 485 (2009) (*citing American Ins. Assn. v. Lewis*, 50 N.Y.2d 617, 623 (1980)). "Nor is the exaction any less a

general revenue-raising measure because it is allocable to a particular project and its amount dependent on the size of the subsidy necessary to sustain the financial soundness of the project it supports. When all is said and done, it is a compulsory contribution for the purpose of defraying the cost of government." *Am. Ins. Ass'n v. Lewis*, 50 N.Y.2d 617, 623, 409 N.E.2d 828 (1980) (citing *Matter of Hanson v. Griffiths*, 204 Misc. 736, 738 (Sup. Ct. Westchester County, 1953), *aff'd*, 283 A.D. 662 (2d Dep't 1954); *Houck v. Little Riv. Drainage Dist.*, 239 U.S. 254, 265 (1915).

The standard of an appropriate regulatory fee was recently illustrated in *Homestead Funding Corp. v. State Banking Dept.*, 95 A.D.3d 1410 (3d Dep't 2012). In that case, the court rejected the claim that the Banking Department's annual assessment on mortgage banks to cover the cost of the Banking Department's regulation of such banks constituted an unconstitutional tax. Instead, the court concluded that the Banking Department assessment was a properly regulatory fee, and not a tax, because "the purpose of the assessments was to recover the Department's expenses related to regulating banks from the banks that are regulated, 'not to raise revenue for the support of government generally.'" 95 A.D.3d 1410, 1411 (3d Dep't 2012) (quoting *American Assn. of Bioanalysts v. Axelrod*, 106 A.D.2d 53, 56 (3d Dep't 1985), appeal dismissed 65 N.Y.2d 847 (1985)).

It cannot be reasonably disputed that Defendants used the Section 332 Special Revenue Account for general state purposes, both through the improper suballocations and then through the sweeps to the General Fund. In contrast to *Homestead Funding*, the suballocated programs are administered by other agencies and do not constitute expenses incurred in the regulation of companies under the Insurance Law. Therefore, Section 332 assessments attributable to the suballocated programs necessarily constitute taxes, and in this case, illegal taxes. In *Torsoe Bros. Constr. Corp. v. Board of Trustees*, 49 A.D.2d 461, 465 (2d Dep't 1975), the Appellate Division held:

> It is well settled that where a license or permit fee is imposed under the power to regulate, the amount charged cannot be greater than a sum

> ***reasonably necessary*** to cover the costs of issuance, inspection and enforcement. To the extent that fees charged are exacted for revenue purposes or to offset the cost of general governmental functions they are invalid as an unauthorized tax. (internal citations omitted) (emphasis added).

In *New York Telephone Co. v. City of Amsterdam*, the Appellate Division, Third Department, quoted this same language from *Torsoe* and went on to hold that:

> Additionally, the fee sought to be imposed "should be assessed or estimated on the basis of reliable factual studies or statistics." ...
>
> Although defendant has characterized the charge as a fee, "[t]he label which is attached to an assessment is not dispositive of its true nature"... Simply stated, taxes are burdens of a pecuniary nature imposed for the purpose of defraying the costs of government services generally ... while fees have been characterized as the "visitation of the costs of special services upon the one who derives a *benefit* from them." (internal citations omitted).

200 A.D.2d 315, 317-318 (3d Dep't 1994). *See also, Phillips v. Town of Clifton Park*, 286 A.D.2d 834, 834-835 (3d Dep't 2001).

The reasonable and necessary standard in *Torsoe Bros* which also is fundamental to Circular A-87, is also supported by the Court of Appeals, which has held that the costs must truly be necessary, not merely desirable or convenient. *Jewish Reconstructionist Synagogue of the North Shore, inc. v. Inc. Village of Roslyn Harbor*, 40 N.Y.2d 158, 163 (1976). In *Jewish Reconstructionist Synagogue*, the seminal case on the limits of regulatory assessments, the ordinance at issue imposed on one seeking a variance the actual costs incurred by the zoning board in passing on the matter. The ordinance also specifically identified certain allowable costs, including, advertising, stenographic minutes, engineering costs, inspection costs, legal fees and recording fees. *Id.* at 160.

The Court held that "the limitation that the fees charged must be reasonably necessary to the accomplishment of the statutory command must also be implied." *Id.* at 163. Stating that the fees should be assessed "on the basis of reliable factual studies or statistics," the Court of Appeals went on to warn of the risk that a board would attempt to recover "not only necessary costs but also any which it,

in its untrammeled discretion, might think desirable or convenient, no matter how oppressive or discouraging they might in fact be for applicants." *Id.*

Applying this standard, the Court upheld the recovery of the costs of publication, technical, engineering and inspection reports. On the other hand, the Court of Appeals held that:

> the charges for legal fees, those for transcribing the record of the proceedings and supplying copies of it to each board member, and those for the rental of a capacious auditorium in which large numbers of spectators could be accommodated at each of the board's sessions, stand in a different footing. They did not represent necessary expenditures but rather conveniences to the board for fulfillment of what in the end was its own decision-making responsibility.

Id. at 165. Thus, finding on the record before it that it was "impossible to assess whether any or all of the charges so incurred were necessary to the accomplishment of the board's decision-making function or merely convenient to it" (*id.* at 166), the Court declared those portions of the ordinance that expressly allowed for those costs to be void and invalid.

The *Jewish Reconstructioninst Synagogue* case not only established the reasonable and necessary standard in regulatory assessment cases, but held that expenditures that are desirable or convenient, but not necessary, are not recoverable, and to the extent a statute authorizes such costs being recovered, it is void and unenforceable. **Thus, the applicable standard is clear. The regulatory fees imposed upon the Section 332 insurers are not to exceed the necessary costs of the regulation of insurance companies that are reasonably and necessarily incurred by the SID.**

In the instant case, Plaintiffs have established that the suballocations do not represent necessary costs. As discussed in detail above, the suballocated programs and the General Fund sweeps are not SID's operating expenses incurred in fulfilling its statutory purpose to supervise and regulate insurers. Those charges therefore cannot be reasonable and necessary "expenses of the [Insurance] department" under Section 332. *See American Ass'n of Bioanalysts v. New York State Dept. of Health*, 75 AD3d 939, 906 (3d Dep't 2010) (affirming the trial court's rejection of the Department of Health's "unreasonably lax

and erroneous" attempt to charge laboratories for the costs of certain materials as direct costs that merely "related in some way" to the goals of DOH.) Indeed, suballocations in the hundreds of millions of dollars to non-CSSAs, such as the Health Department, and for substantive programs, such as Healthy New York, the HMO Direct Pay Program, the Pilot Program for Entertainment Employees, programs relating to building codes and fire prevention, and the Holocaust Claims Processing Office—at least $90,000,000 of which went unused and was swept into the General Fund—do not qualify as the "reasonable and necessary operating expenses incurred in supervising and regulating insurers."

Courts have previously found that fees that SID styled as assessments were actually taxes. In *American Ins. Ass'n v. Lewis*, 50 N.Y.2d 617 (1980), the Court of Appeals held that certain capping fees paid by large insurers as part of a State program, known as the "FAIR Plan," to make insurance coverage available to low income persons constituted taxes because such capping fees bore "not even a rough correlation to the expense to which the State [wa]s put in administering its licensing procedures or to the benefits those who made the payments receive[d]"; such capping fees were applied, not to the SID's operating costs, but to the substantive funding of the FAIR plan – a program that made affordable insurance available to the general public; and such capping fees were "not imposed by an administrative agency charged with regulating licensees, but by the Legislature, the body vested with the power to tax." *Id.* at 622-23. The tax was then invalided on due process grounds because it arbitrarily taxed property outside of the State.

The nature of the FAIR Program at issue in *American Ins. Ass'n* finds clear parallels in the suballocations at issue in this matter, in particular three programs used to make health insurance more affordable: (1) the Healthy New York Program, which provides eligible small businesses with subsidies for employee health insurance and permits employees whose employers do not provide health insurance to purchase coverage through the program; (2) The HMO Direct Pay program which furnishes "stop-loss" funds to health maintenance organizations by assuming liability for costs above a certain level and,

thereby, assists in stabilizing premiums for policy holders who directly purchase insurance coverage; and (3) The Pilot Program for Entertainment Industry Employees ($1,960,000.00), which subsidizes COBRA payments for eligible entertainment industry employees, who experience episodic employment. These programs, which provide benefits to the general public, are therefore directly akin to the programs declared taxes in *American Ins. Ass'n.*

Any doubt that the health insurance subsidies are taxes was removed by the federal court in *United Food & Commercial Workers Unions & Food Employees Benefit Fund v. DeBuono*, 101 F. Supp. 2d 74 (N.D.N.Y. 2000). In that case, the court found that the surcharges to hospitals under the Health Care Reform Act ("HCRA") constituted a tax on hospitals. This is noteworthy because the Healthy New York Program, HMO Direct Pay Program, and the Pilot Program for Entertainment Industry Employees were all funded by HCRA before being shifted to the Section 332 assessment. (*See* pp. 32-34, *supra*; Sherrin Aff. ¶¶61-69.)

The *United Food* court determined that the HCRA surcharges constituted taxes because the charges "serve[d] general revenue raising purposes" and, in contrast to proper regulatory fees, were not designed "to provide narrow benefits to a select group or to defray costs of agency regulation." *Id.* at 78. The court cited HCRA's "chief goals" of "remedy[ing] the perceived evils of uncompensated care for the indigent of New York" and the legislative intent to "maintain or enhance health care access . . . and promote access to primary care." *Id.* The court also noted that the surcharges were used "to ensure that the uninsured 'medically indigent' are not denied essential medical care because of their inability to pay." *Id.* Therefore, the court reasoned, the surcharges were used "to fund 'public goods' related to health care in New York and to finance health care programs that are not otherwise funded, or are inadequately funded, by existing health service payment systems." Thus, the State is barred by the principles of collateral estoppel and *res judicata* from even challenging that charges for the Healthy New York Program, the HMO direct Pay Program, and the Pilot Program for Entertainment Industry

Employees are taxes, and not regulatory assessments. *See*, e.g., *Mulverhill v. State of New York*, 257 A.D.2d 735, 738 (3d Dep't 1999) (holding collateral estoppel applied to State of New York based on United States District Court decision where issue was identical and State "had a full and fair opportunity to contest the prior determination"); *State v. Seaport Manor A.C.F.*, 19 A.D.3d 609 (2d Dep't 2005) ("once a claim is brought to a final conclusion, all other claims arising out of the same transaction or series of transactions are barred, even if based upon different theories or if seeking a different remedy").

The programs the Defendants have shifted to the Section 332 assessment from HCRA are the same programs with the same goals that the court cited in *United Food*, namely increased access to health insurance. The Healthy New York Program was designed "to encourage small employers which do not provide health insurance coverage for their employees to offer such coverage and also designed to ***make coverage available to uninsured employees*** whose employers do not provide group health insurance coverage." N.Y. Comp. Codes R. & Regs. tit. 11, § 362-1.1(a). This program was designed because at the time of the legislation, "a significant number of New York residents were uninsured. Due in part to the rising cost of health insurance coverage, many small employers were unable to provide health insurance coverage to their employees," Healthy New York had the aim to "encourage more small employers and uninsured employed individuals to purchase health insurance coverage." N.Y. Comp. Codes R. & Regs. tit. 11, § 362-1.1(b)(c).

Likewise, the HMO Direct Pay program, also referred to as "Direct Payment Market Stop Loss Relief Program" was designed to compliment Healthy New York by providing "premium and market stability" by establishing "two stop loss funds from which health maintenance organizations may receive reimbursement for certain claims paid on behalf of members covered under individual enrollee direct payment contracts." This reimbursement was designed to effect "a favorable impact on the cost of such coverage for the benefit of both existing enrollees and currently uninsured persons seeking to purchase such coverage." The nature of these programs as taxes does not change simply by shifting the source of

these funds from HCRA to the Section 332 assessment, as the public aims of expanding insurance coverage to previously uninsured or underinsured did not change.

Moreover, the *United Food* court's finding that the surcharges were taxes was explicitly recognized by the SID's General Counsel in a 2010 opinion, issued after the various HCRA programs were shifted to Section 332. (*See* Nardolillo Aff. ¶47 Ex. SS) (noting that *United Food* ruling "in which the HCRA surcharge was deemed a tax for purposes of the Federal Tax Injunction Act . . . .") Therefore, Defendants cannot magically convert the charges for these programs into regulatory fees.

Because the Excess Assessments, financing the above-described Health Department programs and other non-Department suballocations are (1) imposed by the Legislature, (2) deposited into the State General Fund, (3) utilized for the benefit of the general public rather than Plaintiffs, (4) uncorrelated to the State's expense in licensing and regulating insurers, least of all Plaintiff property and casualty insurers, and (5) uncorrelated to any particular benefit received by insurers in return for payments under Section 332 – the Excess Assessments constitute illegal taxes rather than valid regulatory fees.

POINT IV

THE IMPROPER SUBALLOCATIONS AND GENERAL FUND SWEEPS VIOLATE THE SEPARATION OF POWERS DOCTRINES OF THE STATE CONSTITUTION.

New York's system of government is founded on the fundamental principle of separation of powers, in which power is distributed among the three branches of government with a system of checks and balances that prevents excessive concentration of power in one branch. *Rapp v. Carey*, 44 N.Y.2d 157, 162-63, 167 (1978). "Respect for this structure . . . requires that none of these branches be allowed to usurp powers residing entirely within another branch." *Subcontractors Trade Ass'n v. Koch*, 62 N.Y.2d 422, 427 (1984) (citations omitted).

The authority to make laws and establish the policy of the state is the exclusive province of the Legislature. N.Y. Const. art. III, § 1. The executive branch, in contrast, is charged with administering and enforcing the laws created by the Legislature. *Id.* at art. IV; *Bourquin v. Cuomo*, 85 N.Y.2d 781, 784 (1995) (Separation of powers "requires that the Legislature make the critical policy decisions, while the executive branch's responsibility is to implement those policies".). Therefore, the Governor, as the executive of the State, has "only those powers delegated to him by the Constitution," including the power to enforce the laws enacted by the Legislature, and those powers delegated to him by the Legislature. *See Rapp*, 44 N.Y.2d at 166; N.Y. Const. art. IV, § 3.

Likewise, administrative agencies, as creatures of the Legislature within the executive branch, are limited in their actions by the authority granted to them by the Legislature. *Boreali v. Axelrod*, 71 N.Y.2d 1, 6 (1987) (The "scope of [an agency's] authority under its enabling statute must be deemed limited by its role as an administrative, rather than legislative, body.").

The "separation of powers" doctrine in New York mandates that only legislative bodies have the power to impose taxes and such power may not be delegated to the executive or judicial branch. *Walton*

v. New York State Dept. of Correctional Services, 13 NY3d 475, 485 (2009), *citing* NY Const, art III, § 1. "The power to tax is vested exclusively in the Legislature, which power may not be delegated to an administrative agency." *Yonkers Racing Corp. v. State*, 131 A.D.2d 565, 566 (2d Dep't 1987) (citing N.Y. Const., art. III, § 1; *Matter of U.S. Steel Corp. v. Gerosa,* 7 N.Y.2d 454 (1960); *Gautier v. Ditmar,* 204 N.Y. 20 (1912); *Matter of Rego Props. v. Finance Administrator of City of N.Y.,* 102 Misc.2d 641 (Sup. Ct. Spec. Term Queens County 1980).

To the extent that Section 332 merely calls for the imposition of the direct and indirect costs of operation of SID, SID has violated the separation of powers doctrine by illegally and unconstitutionally usurping the power to tax that resides exclusively in the Legislature. Second, to the extent that the Legislature has authorized SID to exercise this taxing function, the Legislature has also violated the separation of powers doctrine and Article III, Section 1 of the NYS Constitution by unconstitutionally delegating its exclusive authority to tax, and by directing that the unused assessments be swept into the General Fund. The sweeps impermissibly "blur[] the distinction between the executive power to assess regulatory fees and the legislative power to tax for general purposes." *See, Haw. Insurers Council v. Lingle*, 201 P.3d 564, 583 (Haw., Dec 18, 2008).

Other states have rejected such sweeps as unconstitutional. In *Haw. Insurers Council, supra*, the State of Hawaii's insurance department also funded itself entirely on assessments upon insurers regulated by that department. Unlike New York's law, any overpayment of the assessment was not returned to the insurers. Rather, the Hawaii insurance department was allowed to keep these funds and build a surplus, although the surplus was not allowed to revert to Hawaii's state general fund. Because Hawaii's insurance department had been running a surplus in the assessment fund, the Hawaii legislature passed laws to transfer $3,500,000 from the insurance fund into the state's general fund for the purpose of balancing the state's budget. While the court found that the collection of the assessment was not a tax, because it was "used for the regulation or benefit of the parties upon whom the assessment is

imposed," and was spent on items which assisted Hawaii's insurance department "in carrying out its regulatory functions," 201 P.3d at 580, the court struck down the $3,500,000 transfer to the Hawaii general fund. The court found that the separation of powers doctrine was violated because, via the transfer statutes, the Hawaii legislature "unlawfully sought to divert legitimate regulatory fees into the general tax revenue stream" and that "the legislature's promulgation of the transfer bills amounted to an impermissible blurring of the distinction between the executive power to assess regulatory fees and the legislative power to tax for general purposes." *Id.* at 583. The court ordered the transfer cancelled and the funds returned.

The California Supreme Court reached a similar conclusion in *Daugherty v. Riley*, 1 Cal. 2d 298 (Cal. 1934), ordering that funds transferred in a legislative appropriation from an insurance assessment fund to the general fund needed to be returned to the insurance fund, because the Legislature "may not on the one hand set up a department to authorize, regulate, and supervise business transactions large and small, imposing fees upon those affected for the purpose of carrying out the purposes of the law, and on the other hand permanently divert the funds thus raised and constituting the life blood of the department to a general fund or other general tax purpose." *Id.* at 309.

In the instant case, the sweeps into the State General Fund of the unused Section 332 assessments impermissibly blurs the distinction between the executive power to assess regulatory fees and the legislative power to tax for general purposes, and, thereby, violates Separation of Powers. Accordingly, any General Fund Transfers under the TEA Statutes are unconstitutional and must be returned to Plaintiffs pursuant to Section 332(b) of the Insurance Law.

POINT V

THE ASSESSMENTS CONSTITUTE AN UNCONSTITUTIONAL *AD VALOREM* TAX UPON INTANGIBLE PROPERTY PROHIBITED BY ARTICLE XVI, § 3 OF THE STATE CONSTITUTION

Additionally, if the Section 332 assessment of suballocated costs is deemed a tax, the assessments which funded the improper suballocations and the General Fund Transfers comprise an unconstitutional *ad valorem* tax upon Plaintiffs' intangible property in violation of Article XVI, § 3 of the New York State Constitution, which mandates that "intangible personal property [such as 'moneys, credits, securities,' etc.] shall not be taxed *ad valorem* [according to the value] nor shall any excise tax be levied solely because of the ownership or possession thereof." An *ad valorem* tax is one that is imposed solely on the basis of property ownership or possession, according to its value, and not on the basis of the property's use. *Ampco Printing-Advertiser's Offset Corp. v. New York*, 14 N.Y.2d 11, 22 (1964). On the other hand, a tax upon intangible property, e.g. Plaintiffs' insurance contracts, may never be based solely on ownership or possession, and may only be based upon that property's use. Because the suballocated programs do not meet such requirements for proper taxes and are, instead, unlawfully imposed according to the value of Plaintiffs' intangible property, i.e. insurance contracts (as measured by premiums) within the State, they constitute unlawful *ad valorem* taxes in violation of the State Constitution.

Contracts, including Plaintiffs' insurance contracts, constitute intangible property. *See ABKCO Industries, Inc. v. Apple Films, Inc.*, 39 N.Y.2d 670, 674 (1976); *Black's Law Dictionary* 1336-1338 (9th ed. 2009) (intangible property is "[p]roperty that lacks a physical existence"). Nor is there any question that the Section 332 assessments, which are imposed in proportion to Plaintiffs' share of "premiums and other considerations, written or received by insurers in this State," are imposed according to the value of

Plaintiffs' intangible property, i.e. insurance contracts (as measured by premiums).

It is important to note that the Section 332 assessment is not a tax on premiums. Although a subject insurer's share of the assessment is determined by calculating the proportion of that insurer's premiums to the entire pool of premiums of all covered insurers, the Section 332 assessment is still an *ad valorem* tax because it is based solely on the ownership of rights or obligations under an insurance contract. The use of the premiums is just the mechanism to calculate what proportion of the assessment each insurer would pay.

That distinction is critical because an *ad valorem* tax is "always based on ownership of property and is payable regardless of whether the property is used or not." *Ampco Printing*, 14 N.Y.2d at 22. Under that definition, the Section 332 assessment of suballocated costs is an illegal tax based solely on the existence of a contract, and not on the premiums earned from it. This is illustrated by a how the insurance assessment works. The assessment is divided among the eligible insurers, *pro rata*, and each insurer's share is calculated by the relative percentage of its premiums to the size of entire pool of premiums. Because the total dollar amount of suballocated programs in the Section 332 assessment is fixed in the budget and thus is unaffected by any fluctuations in premiums, the Section 332 assessment of suballocated costs cannot be a tax on income. Indeed, an insurer's Section 332 obligations may increase even when its premium income drops if the premium income of other insurers in the pool drop more. Likewise, an insurer's assessment payment could drop, even if its premium income rose, if other insurers enjoyed a larger percentage of premium income gains. Therefore, the Section 332 assessments constitute illegal *ad valorem* taxes.

POINT VI

THE EXCESS ASSESSMENTS VIOLATE THE EQUAL PROTECTION PROVISIONS OF THE STATE AND FEDERAL CONSTITUTIONS.

"The integrity of any system of taxation ... rests upon the premise that similarly situated taxpayers pay the same share of the tax burden." *Foss v. City of Rochester*, 65 N.Y.2d 247, 254 (1985). The Defendants' conversion of the Section 332 assessments into a tax should be declared illegal because the imposition of the taxes for the benefit of the general public or private third parties on just the Plaintiffs violates the Equal Protection Clauses of both the U.S. Constitution (U.S. Const. 14th amend) and New York State Constitution (Article I, § 11). Those sections command that "persons similarly-situated should be treated alike." *Walton v. New York State Dept. of Correctional Services*, 13 N.Y.3d 475, 492 (2009), quoting *Cleburne v Cleburne Living Center*, 473 U.S. 432, 439 (1985) (other internal citations omitted).

Classifications that create distinctions between similarly situated individuals must be struck down unless they are rationally related to a legitimate government interest, *Walton*, 13 N.Y.3d at 492, or the "disparate treatment is so unrelated to the achievement of any combination of legitimate purposes that it is irrational" *Affronti v. Crosson*, 95 N.Y.2d 713, 719 (2001) (quoting *Kimel v. Florida Bd. of Regents*, 528 U.S. 62, 84 (1999) (internal quotation marks omitted)). Furthermore, a taxing classification that is unequal in application must be declared unconstitutional if it is "palpably arbitrary." *Town of Tonawanda v. Ayler*, 68 N.Y.2d 836, 837 (1986) (citations omitted). It is black-letter law that "intentional or purposeful discrimination in the administration of an otherwise nondiscriminatory law violates equal protection." *People v. Goodman*, 31 N.Y.2d 262, 268 (1972) (citing *Yick Wo v. Hopkins*, 118 U.S. 356 (1886)). The domestic insurers covered by Section 332 comprise a "discrete and objectively identifiable class" sufficient to trigger an equal protection analysis. *See generally Port Jefferson Health Care Facility v. Wing*, 94 N.Y.2d 284, 290 (1999) (quoting *San Antonio Ind. School Dist. v. Rodriguez*, 411 U.S. 1, 22 (1973) (Stewart,

J., concurring). This class is similarly situated to, but treated disparately from, the general public, who are the true beneficiaries of the suballocated programs. The suballocated programs are intended to benefit the public generally, not the Plaintiffs or domestic insurers specifically, yet the domestic insurers alone are forced to bear the costs of the suballocated programs.

In imposing hundreds of millions of dollars for the suballocated programs to pay for those public- and private-benefit programs (i.e. taxes) solely upon Plaintiffs and other domestic insurers Defendants are unreasonably and irrationally treating Plaintiffs differently than other similarly situated general beneficiaries of public-benefit programs. *See Foss*, 65 N.Y.2d at 259 (invalidating a tax treating residents within county differently despite "owning similar property and receiving the same services").

Defendants have not demonstrated any rational basis for doing so, creating a "palpably arbitrary" classification between Plaintiffs and other similarly situated taxpayers. The Court should therefore declare that the Section 332 assessment of the suballocated programs are null and void and order a refund of the improperly collected taxes.

POINT VII

THE ASSESSMENTS AND GENERAL FUND TRANSFERS CONSTITUTE AN UNLAWFUL TAKING WITHOUT JUST COMPENSATION UNDER THE STATE AND FEDERAL CONSTITUTIONS.

Pursuant to both Article I, § 7 (a) of the New York State Constitution, which provides that "[p]rivate property shall not be taken for public use without just compensation," and the Fifth Amendment to the Federal Constitution, which provides that "nor shall private property be taken for public use, without just compensation," the Excess Assessments (and accompanying General Fund Transfers) constitute a taking because it is "direct government appropriation or physical invasion " of Plaintiffs' private property without just compensation. *Lingle v Chevron U.S.A., Inc.*, 544 U.S. 528 (2005). *See also Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

In the present case, the Section 332 assessments constitute a taking because they constitute a direct appropriation of Plaintiffs' property to fund general state operations and programs, and do not qualify as regulatory assessments for their own benefit. A taking is not limited to real property. Both tangible and intangible property may be the subject of takings claims. *See Maritrans Inc. v. United States*, 342 F.3d 1344, 1351 (Fed. Cir. 2003), *citing Ruckelshaws v. Monsanto Co.*, 467 U.S. 986 (1984).

The Section 332 assessments, totaling hundreds of millions of dollars annually, affect a "direct government appropriation" of Plaintiffs' monies for the benefit of third parties, and Defendants have provided Plaintiffs with no compensation at all. Therefore, the Section 332 assessments Excess Assessments comprise an illegal "taking without just compensation" and are constitutionally null and void.

Defendants' actions in this case are analogous to the unconstitutional taking in *Hospital Ass'n of New York State v. Axelrod*, 113 A.D.2d 9 (3d Dep't 1985). In that case, the Legislature passed a law,

known as the Medical Malpractice Reform Act, which required, *inter alia*, that each general hospital in the State purchase excess coverage for any physician or dentist affiliated with the hospital. It was undisputed that the legislation was designed to pass on the costs of this insurance to third party payors of inpatient care charges, including Medicare and Medicaid, with no charge to the hospitals. However, the Department of Health and Human Services advised that the Medicare program would not reimburse the cost of the excess malpractice insurance premiums. That decision, combined with a determination by the State DOH that the hospitals would not be able to turn to the Medicaid program for the reimbursement, meant that the hospitals would be required to bear the expense of the insurance attributable to Medicare, estimated at $16,000,000. 113 A.D.2d at 10-12.

The *Hospital Ass'n* court found that if the statute allowed the State to escape reimbursement of the hospitals for the cost of the excess insurance, then the statute would affect an unconstitutional taking because the losses to the hospital, even if less than the estimated amount, were substantial and the hospitals did not enjoy any direct benefit from the increased malpractice insurance. *Id.* at 15. The court noted that "[t]he ultimate evil of a deprivation of property, or better, a frustration of property rights, under the guise of an exercise of the police power is that it forces the owner to assume the cost of providing a benefit to the public without recoupment." *Id.* at 16 (quoting *French Investing Co. v. City of New York*, 39 N.Y.2d 587, 596 (1976), *appeal dismissed*, 429 U.S. 990 (1976), *rearg. denied*, 40 N.Y.2d 846 (1976)). The Medical Malpractice Reform Act's requirement that hospitals shoulder the expense of the excess insurance coverage would have amounted to an unconstitutional taking because "the only direct beneficiaries of . . . the Act are private doctors and dentists who are neither the employees nor agents of the general hospitals and who are to be provided excess malpractice insurance covering activities which may have no connection whatsoever with inpatient hospital care." *Id.* at 15. The fact that the hospitals may have enjoyed some indirect benefit from the Act through the assurance that "practitioners [would] continue to function and admit patients to their facilities," did not change the court's analysis because

"[t]he appropriation of [the hospitals'] property [was] absolute." *Id.* at 15-16. In order to save the constitutionality of the Act, the court ordered the State to reimburse the hospitals for the uncovered portion of the excess insurance premiums. *Id.* at 17-18.

Cited by the *Hospital Ass'n* court in support of its decision, and also analogous to the instant matter, was the situation in *Matter of Herkimer Pulp & Packaging Corp. v. McMorran*, 45 Misc. 2d 127 (Sup. Ct., Albany County, Spec. Term 1964), *aff'd* 24 A.D.2d 929 (1965), *leave denied*, 17 N.Y.2d 423 (1966). In *Herkimer Pulp*, the state Superintendent of Public Works issued an order, under Section 948 of the Conservation Law, requiring a manufacturing company to pay for the entire cost of flood control improvements upon its property, which would inure to the benefit of the Village of Herkimer. The court found that Conservation Law § 948 was a statute of "regulation and not appropriation" and that the project, ordered "under the guise of regulation," was "obviously for a public use and purpose" and amounted to an order to compel the manufacturer to allow his property to be used for a "flood control project" and to bear the costs of improving the property "for that purpose, all without compensation." 45 Misc. 2d at 134. The court thus rejected the Superintendent's order as an attempt to use the State's police power "to circumvent the constitutional inhibition against appropriating private property for a public use without compensation." *Id.* at 134-135. The court ultimately passed on the constitutional question because it held "that Section 948 of the Conservation Law was never intended to apply to the situation" and, therefore, the Superintendent's order was improperly issued. *Id.* at 135.

In the present case, similar to the situations in *Hospital Ass'n* and *Herkimer Pulp,* the Excess Assessments—disguised as "operating costs" under Insurance Law § 332, but funding Health Department and other programs that have nothing to do with the regulation of Plaintiffs—are depriving Plaintiffs of many millions of dollars without reimbursing them or providing them with equivalent direct benefits. Furthermore, the suballocated programs are also charged to Plaintiffs "under the guise of regulation" and Plaintiffs are paying for programs which have broad public purposes, a fact that

Defendants themselves even tout. *See* LaBate Aff. ¶27 (suballocations purportedly justified as indirect costs, benefit "all consumers in New York"). Like *Hospital Ass'n* and *Herkimer Pulp*, Plaintiffs should not be forced to bear the sole brunt of public benefit programs.

In addition to the improper suballocated programs, the sweeps the Defendants executed also constituted a taking of funds that, because they were not expended, needed to be returned to the insurance companies assessed. Aside from the fact that Plaintiffs had a property interest in the funds that Defendants assessed under Section 332, Plaintiffs also had an interest in the return of those funds if they were not spent or expended. Under Section 332, "[a]ny overpayment of annual assessment resulting from complying with the requirements of this subsection shall be refunded or at the option of the assessed applied as a credit against the assessment for the succeeding fiscal year." N.Y. Ins. Law § 332(b) (2011). This refund occurs "upon determination of the actual amount due" for the expenses of the SID for that fiscal year. *See id.* If the suballocated programs do not expend the funds which the Plaintiffs were assessed for, these cannot be the expenses of the SID. There can be no doubt that these funds, having not been spent by the suballocated programs, are not expenses of the SID and therefore the Plaintiffs have been overassessed in those situations.

The return of funds under this provision is supported by the decision of the Court of Appeals in *Alliance of American Insurers v. Chu*, 77 N.Y.2d 573 (1991). In that case, plaintiff insurance companies challenged the state's transfer of monies from the Property and Liability Insurance Security Fund, first created to cover claims and motor vehicle liability policies in the event of an insurer's insolvency and then expanded to cover various forms of property and liability insurance, to the State's General Fund. The monies in the Property and Liability Insurance Security Fund came from insurance companies that contributed to the fund based on a percentage of premiums received on covered insurance policies. The State's diversion of fund income to the General Fund was designed to offset an anticipated loss of revenue from tax cuts benefiting insurers. *Alliance of American Insurers v. Chu*, 77 N.Y.2d at 581.

The Court of Appeals found that certain of these transfers to the General Fund were illegal takings because funds covered by the 1969 version of the statute provided that any "income earned on new contributions to the fund would be either returned to the contributors or credited towards future contributions." *Alliance of American Insurers v. Chu*, 77 N.Y.2d at 580 (citing N.Y. Ins. Law § 334(5)).

Plaintiffs in *Alliance of American Insurers* challenged the transfers on the basis that they "constituted a taking of their property without compensation, a deprivation of property without due process and an impairment of the State's contractual obligations to them, all in violation of familiar State and Federal constitutional guarantees." *Id.* at 584 (citing U.S. Const, art I, § 10, cl 1; 5th, 14th Amends; NY Const, art I, §7). The Court agreed, only reaching the plaintiff' claim of a property interest in the funds, because it found it dispositive. *Id.* According to the Court, the 1969 version of the statute "gave the contributors a property interest in income attributable to their contributions by providing for its return or credit to them" and even noted that had the Superintendent of Insurance failed to pay or credit insurers for this income, "the contributors could have asserted a legitimate 'claim of entitlement' to the moneys, grounded in the statutory guarantee.'" *Id.* at 585 (quoting *Board of Regents v Roth*, 408 U.S. 564, 577 (1972)). Therefore, the Court found that the insurers' right to the income attributable to their contributions under the statute "may not be extinguished by the state." *Alliance of Am. Insurers v. Chu*, 77 N.Y.2d at 586. The Court of Appeals ordered the Defendants to return the income swept into the general fund to the insurers. *Id.* at 590.

The result should be no different here. Plaintiffs had a right to any unspent assessments pursuant to Section 332. These funds were maintained in the 339 B6 special revenue fund, which, by definition, is a type of fund "specifically restricted by law from being deposited in the general fund of the state." N.Y. State Fin. Law § 2 (McKinney). The fact that these funds were not used for the suballocated programs meant that these funds could not be considered "expenses" of the SID and therefore were not properly assessable. The result is that the Plaintiffs have overpaid the assessment for

those fiscal years and must receive return of the funds.

POINT VIII

THE EXCESS ASSESSMENTS, VIOLATED THE CONSTITUTIONAL REQUIREMENTS OF ARTICLE III, § 22 OF THE NEW YORK STATE CONSTITUTION.

Because the Section 332 assessment of the suballocated programs constitute taxes upon Plaintiffs' property for the benefit of the general public and certain non-Insurer individuals, and Defendants are imposing the taxes absent the State Constitution's specificity requirements for imposing taxes in Article III, § 22, the Excess Assessments and TEA Statutes are unconstitutional and Defendants must refund the entire assessment amounts.

Article III, Section 22 of the New York State Constitution holds that "[e]very law which imposes, continues or revives a tax shall distinctly state the tax and the object to which it is to be applied and it shall not be sufficient to refer to any other law to fix such tax or object". The Courts have held that a tax is distinctly stated when it identifies the type of tax and the purpose for which the funds generated by the tax are to be applied. *See People of State of N.Y. v. The Home Ins. Co.*, 92 N.Y. 328 (1883).

In the first instance, the assessments and laws at issue in this case should be struck down because they fail to state the tax or the object. In *People ex rel. Hopkins v. Kings County Sup'rs*, 52 N.Y. 556 (1873), the Court of Appeals invalidated a tax for reasons analogous to the situation here. In *Hopkins*, the Legislature passed a law that levied a tax to pay for the construction of a canal and certain "general fund deficiencies directed to be paid by [another law], chapter 700 of the Laws of 1872." 52 N.Y. at 567. The law imposed a tax "of three and a half mills [3.5/1000s] per dollar, or so much thereof as may be necessary," to pay for those items. *Id.*

The Court of Appeals found that the law violated the precursor of Section 22 because it failed to state the rate of the tax or the object. The qualifier to the tax rate "or so much thereof as may be

necessary" was "not a specific and distinct statement of the tax to be levied," but rather was "simply a statement of the maximum tax." In the eyes of the Court, this left it to "the ***discretion of the administrative officers of the State*** to levy such tax as they shall find necessary up to the limit named." *Id.* (emphasis added). The Court therefore found this tax not only to be an inadequate description of the tax under the state constitution, but also an improper delegation of the authority to tax by the Legislature, due to the fact it left it to the discretion of officers of the State to ultimately set the final level of the tax. *Id.*; *see* Point IV, pp. 63-65, *supra.*

In addition to failing to state the rate of tax, the *Hopkins* Court also struck down the tax on the basis that it cited to another law to fix the object. However, not only did the law violate the Constitution by referring to another law, *see id.* at 567-568, but in discussing the purported objects of the tax in the context of other Constitutional requirements, the Court of Appeals found that "[t]he objects and purposes . . . for which taxes shall be levied, are very much, if not entirely, in the discretion of the legislature," *id.* at 564, because the Legislature ultimately possessed discretion to decide the particular appropriations year after year. Thus the definition of the object of the tax was lacking, because the Legislature had the discretion to choose whether to pay the appropriations or not, and "the discretion and responsibility is with them as if no former appropriations had been made." *Id.* at 565.

Like the tax in *Hopkins*, the *de facto* taxes levied pursuant to Section 332 and the TEA statutes also fail to state the amount of the tax, and not just because the charges levied upon domestic insurers were not formally identified as a "tax." Additionally, under Section 332, the amount of the insurance assessment is set by the Superintendent of Insurance and approved by the Director of the Budget, thus leaving it to those agencies to set the tax when they approve the final assessment programs and the amounts of those programs. Similarly, the TEA Statutes directed the Superintendent of Insurance to charge insurers for the "total enacted appropriations" of SID for certain fiscal years. As demonstrated above, these categories and potential appropriations were only limited by Defendants' imagination, and

these appropriations could vary tremendously from year to year. The statutes also require one to refer to another law to set the tax; the TEA statutes refer to previous budget bills to set the amount charged to the Section 332 insurers.

Furthermore, the rate of tax is unknown as the Section 332 charges are *pro rata*, and vary based on the number of insurance policies written by other insurers, thus the rate of the *de facto* tax changes annually. The indefinite, discretionary appropriations and changing burdens under a *pro rata* apportionment are in stark contrast to a straight rate of tax, which the *Hopkins* Court held would have been appropriate. *Id.* at 266 ("The [three and a half mills] tax would have been well specified in amount but for" the "as may be necessary clause").

Section 332 must also be struck down, like the tax in *Hopkins*, because that object of the tax is not sufficiently stated. The supposed object of the tax would be the operating expenses of SID. However, as described above and like the purported tax objects in *Hopkins*, the Section 332 suballocated programs are completely discretionary and can change from year to year as SID, with the approval of the Division of Budget, submits new suballocations in new amounts to the Legislature in SID's annual budget request. The fact that the object of the tax can change annually, like the tax in *Hopkins*, confirms that Section 332 suballocated programs constitute an illegal tax.

Because the Legislature failed to satisfy the specificity requirements of Article III, § 22 of the New York Constitution, the Excess Assessments and General Fund Transfers are null and void and must be refunded to Plaintiffs.

POINT IX

THE PROPERY REMEDY IS TO RETURN THE EXCESS ASSESSMENTS TO THE PLAINTIFFS.

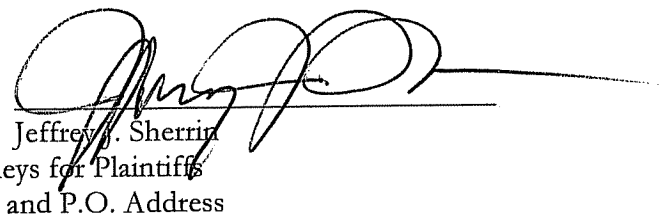
Plaintiffs are entitled to a refund of the improperly assessed suballocations. Courts in this state have previously ordered improperly collected assessments to be returned to the entity paying the assessments. In *American. Ass'n of Bioanalysts v. Axelrod*, 130 A.D. 2d 889 (3rd Dep't 1987), the Third Department held that clinical laboratories were entitled to a full refund of the amounts that exceeded the necessary costs of regulating those laboratories. *See also Matter of Home Off. Reference Lab. v. Axelrod*, 176 A.D. 2d 858, 861 (3d Dep't 1986), *leave denied* 68 N.Y.2d 601 (1986). Plaintiffs should also receive a full refund of the Section 332 assessment attributable to suballocated programs which have no relation to the costs SID incurs in the regulation of insurers.

CONCLUSION

Based on the foregoing, Plaintiffs respectfully request that this Court declare the suballocations charged to Plaintiffs from fiscal years 2007-2008 to 2011-2012 to be illegal and unconstitutional, and order that the Excess Assessments be refunded to the Plaintiff insurers.

DATED: November 22, 2013

O'CONNELL AND ARONOWITZ
By:



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