



DC CIRCUIT SHUTS DOWN ANOTHER FEDERAL REGULATORY “SWITCHEROO”

by Lawrence S. Ebner

Switcheroo (swi-chə-rü) *n.*—“An unexpected reversal or change.” WEBSTER’S II NEW RIVERSIDE UNIVERSITY DICTIONARY (Houghton Mifflin Co. 1988).

Springing a switcheroo on a regulated industry is exactly what the federal Administrative Procedure Act (“APA”) notice-and-comment rulemaking procedures, 5 U.S.C. § 553, are intended to prevent.¹ As the recent ruling in *Allina Health Services v. Sebelius*,² illustrates, the U.S. Court of Appeals for the D.C. Circuit remains willing to strike down final regulations that represent a volte-face from a federal department or agency’s notice of proposed rulemaking. Regulated industries encountering similar behavior from federal agencies should take note.

The APA’s “informal” (*i.e.*, notice-and-comment) rulemaking procedures

are designed (1) to ensure that agency regulations are tested via exposure to diverse public comment, (2) to ensure fairness to affected parties, and (3) to give affected parties an opportunity to develop evidence in the record to support their objections to the rule and thereby enhance the quality of judicial review.³

These objectives cannot be achieved if a federal agency, without prior notice or opportunity for further comment, issues a final rule (*i.e.*, regulation) that in one or more material ways is the opposite of, or materially different from, the proposed rule published in the agency’s APA § 553 notice of proposed rulemaking.

Under § 553(c), an “agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments,” and also must ensure “consideration of the relevant matter presented.” This “opportunity to comment is provided by § 553(c) with the expectation that comments often will persuade agencies to make changes from their original proposal or to adopt alternatives to their original proposal.”⁴ But “an agency does not have complete discretion to change radically a proposed rule simply in response to adverse comments.”⁵ Nor can a final rule abruptly alter direction simply because political winds shifted after the rule was proposed. Instead, the D.C. Circuit and other federal courts of appeals have adopted the “logical outgrowth” doctrine: “[A]n agency’s proposed rule and its final rule may differ only insofar as the latter is a ‘logical outgrowth’ of the former.”⁶ The logical outgrowth doctrine strikes a balance “between the agency’s need to change its rules because of what it learns during the comment period and the public’s right to participate meaningfully in the promulgation of the final rule.”⁷

The D.C. Circuit’s *Allina Health Services* opinion, authored by Senior Circuit Judge Laurence Silberman, demonstrates that the logical outgrowth doctrine continues to provide regulated industries with due-process protection against previously unannounced, politically expedient, federal agency reversals-of-position in final rules. The plaintiffs, hospitals that serve elderly, low-income patients, challenged a 2004 final rule that the U.S. Department of Health and Human Services (“HHS”) issued under the Medicare program. The challenged regulation involves the method by which HHS calculates the supplemental compensation (*i.e.*,

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reimbursements) to which hospitals that serve indigent patients are entitled. Those supplemental payments “are determined by calculating what is called the ‘disproportionate share percentage’—a formula which is a proxy for the percentage of low-income patients served.” *Allina*, 2014 WL 1284834, at *1. The outcome of that complicated calculation ultimately depends on a question of statutory interpretation: whether Medicare beneficiaries who elect to participate in Medicare Part C (allowing beneficiaries to obtain Medicare coverage from private health insurance companies) also are “entitled to benefits under Part A” (traditional Medicare coverage). Suffice it to say that if the answer is *no*, the plaintiff hospitals “receive a great deal more compensation.” *Ibid.*

In 2003, the Secretary of HHS issued a notice of proposed rulemaking “proposing to clarify” the then-existing policy that Medicare beneficiaries who elect Part C coverage are *not* entitled to benefits under Part A. *Id.* at *2. That was fine with the hospitals, which largely refrained from commenting on the proposed rule. But “[t]he next year the Secretary announced a final rule adopting the exact opposite interpretation.” *Ibid.* This regulatory flip-flop would decrease the plaintiff hospitals’ payments by tens of millions of dollars per year. *Id.* at *3.

The district court vacated the final rule on the ground that it was not the logical outgrowth of the proposed rule, and the D.C. Circuit affirmed (reversing only the district court’s directive that HHS recalculate the hospitals’ reimbursement percentages). Citing D.C. Circuit precedent, the court explained that “[a] final rule is a logical outgrowth if affected parties should have anticipated that the relevant modification was possible.” *Id.* at *3. The court agreed with the hospitals that there was nothing in the notice of proposed rulemaking’s “text . . . to suggest that the Secretary was thinking of reconsidering a longstanding practice.” *Ibid.* “The hospitals should not have been held to have anticipated that the Secretary’s ‘proposal to clarify’ could have meant that the Secretary was open to reconsidering existing policy.” *Id.* at *4.

The court of appeals also emphasized that the notice of proposed rulemaking asserted that the HHS “clarification” would not have a major financial impact. If instead, the notice had suggested that HHS was considering a policy change that would cause hospitals to lose hundreds of millions of dollars in Medicare reimbursement payments, “[t]hat would doubtless have triggered an avalanche of comments, in contrast to the mere 26 pages that were actually submitted.” *Ibid.* The court asked, “would a reasonable member of the regulated class—even a good lawyer—anticipate that such a volte-face with enormous financial implications would follow the Secretary’s proposed rule”? *Id.* at *5. Because the answer was *no*, the D.C. Circuit “agree[d] with the district court that the Secretary’s final rule was not a logical outgrowth of the proposed rule.” *Ibid.* In view of the Secretary’s unlawful switcheroo, the court further held that vacatur (*i.e.*, nullifying the final rule) was the appropriate remedy because “deficient notice is a ‘fundamental flaw’ that almost always requires vacatur,” and “there is no indication that vacatur would lead to disruptive consequences,” *i.e.*, “[t]his is not a case in which the ‘egg has been scrambled.’” *Id.* at *7.

The take-away message for federally regulated industries and businesses from *Allina Health Services* and its predecessors is to know your due process rights under the APA’s rulemaking procedures, and to consider seeking judicial recourse if a federal department or agency engages in a regulatory backflip. In addition, this ruling suggests that the D.C. Circuit should continue to be the forum of choice for such challenges.

(Endnotes)

¹ See *Env’t Integrity Project v. EPA*, 425 F.3d 992, 996 (D.C. Cir. 2005) (“[W]e have refused to allow agencies to use the rulemaking process to pull a surprise switcheroo on regulated entities.”).

² Nos. 13-5011, 13-5015, 2014 WL 1284834 (D.C. Cir. Apr. 1, 2014).

³ *Int’l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 407 F.3d 1250, 1259 (D.C. Cir. 2005).

⁴ Richard J. Pierce, Jr., *ADMINISTRATIVE LAW TREATISE* § 7.3 at 573 (Wolters Kluwer eds., 5th ed. 2010).

⁵ Jeffrey S. Lubbers, *A GUIDE TO FEDERAL AGENCY RULEMAKING* 285 (American Bar Association, 4th ed. 2006).

⁶ *Env’t Integrity Project*, 425 F.3d at 996; see also *Shell Oil Co. v. EPA*, 950 F.2d 741, 747 (D.C. Cir. 1991) (holding that adequate notice has been provided for APA purposes “so long as the final rule is a ‘logical outgrowth’ of the one proposed”).

⁷ Philip M. Kannan, *The Logical Outgrowth Doctrine in Rulemaking*, 48 *ADMIN. L. REV.* 213, 215 (Spring 1996).