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New York State Agencies Issue Proposed Regulations Regarding the Administration Expenses and Executive Compensation of State-Supported Entities

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Pursuant to Executive Order 38 issued by Governor Cuomo, thirteen New York State agencies released very similar proposed regulations on May 16, 2012, placing a limit on the funds that can be used for administrative expenses and executive compensation by entities, both for-profit and not-for-profit, that receive state funds or state-authorized payments to provide services. These regulations are generally available for public comment from May 30, 2012 to July 14, 2012, and are scheduled to become effective on January 1, 2013.

What Service Providers Are Affected?

The proposed regulations apply to certain providers of program services. Program services are defined as services that are paid for, in whole or in part, with state funds or state-authorized payments, and which are rendered to and for the benefit of members of the public. Program services exclude services provided for the benefit or on behalf of the state or authorizing agency, assistance to a state agency or local unit of government in its provision of services to the public, and policy development or research.

Generally, a service provider is subject to these regulations if it has an agreement with an agency or governmental entity to receive state funds or state-authorized payments averaging over $500,000 a year for purposes of providing program services. Additionally, state funds or state-authorized payments must constitute at least 30% of a service provider's (including any parent's or subsidiary's) annual in-state revenues. "Annual in-state revenues" is not defined in the regulations.

State funds and state-authorized payments generally include funds allocated in the annual state budget, payments made upon the approval of a New York state agency or governmental unit, and payments made by virtue of the service provider holding a license to provide the services. The proposed regulations do not define the scope of the provision as it relates to holding a license, and further guidance will, hopefully, be coming shortly to limit the broadness of this provision. Certain payments are excluded from the definition, including many state procurement contracts, all capital expenses, most awards made to governmental units, payments or vouchers for specific services made to individual members of the public, subsidies to support hiring or retention, and payments for policy development or research.

What Are the Limitations Regarding Administrative Expenses?

The proposed regulations require a service provider to use at least 75% of the state funds or state-authorized payments it receives to provide program services, rather than to pay for administrative expenses. This percentage requirement will increase by five percent each year, until it reaches 85% in 2015.

"Administrative expenses" under the proposed regulations are a service provider's management and overhead expenses that are not directly attributable to program services. For example, administrative expenses include most legal and office operating expenses, as well as the compensation of staff members who are not directly involved in providing program services. However, the proposed regulations specifically exclude capital expenses, property rental or maintenance, equipment rental, and depreciation and interest expenses.

If a subcontractor or agent of a service provider is considered a related entity and it receives state funds or state-authorized payments from the service provider, it is also subject to the limitations on administrative expenses. Additionally, the service provider is required to report the identity of the subcontractor or agent, along with any other information requested, to the authorizing agency.

A "related entity" for purposes of these regulations is one that meets any of the following criteria:

- An entity that has 3 or more officers, directors, trustees or employees in common with those of the service provider;

- An entity that appoints 25% or more of the service provider's officers, directors, trustees or employees;

- An entity that has 25% of its officers, directors, trustees or employees appointed by the service provider;

- An entity that is, along with the service provider, a subsidiary owned or controlled in whole or in part by a common parent;

- Any entity that owns any interest in the capital or profits of the service provider, either directly or through one or more entities;

- Any entity in which the service provider owns any interest in the capital or profits, either directly or through one or more entities;

- An entity that substantially controls the executive compensation or financial affairs of the service provider; or

- An entity with executive compensation or financial affairs substantially controlledby the service provider.

What Are the Limitations Regarding Executive Compensation?

The proposed regulations prohibit the use of more than $199,000 of state funds or state-authorized payments to compensate a director, trustee, managing partner, officer or other employee whose salary is at least partly an administrative expense. The last classification, an employee whose salary is at least partially an administrative expense, requires further guidance to determine whether the state is targeting persons below the top level who have relatively minor administrative responsibilities compared to their other responsibilities.

This limitation on executive compensation applies to service providers as well as to any related entity with which a service provider contracts for administrative or program services.

Service providers may pay an executive more than $199,000, provided certain requirements are met, or a waiver is obtained. The requirements are:

- The excess compensation must come from sources other than state funds or state-authorized payments (as noted above, still open to clarification).

- If compensation exceeds the $199,000 limit, the service provider must show that the executive's total compensation is below the top quartile in his or her field, according to a compensation survey recognized by the relevant agency and the Division of the Budget. The agencies have yet to clarify what surveys will be utilized.

- The executive's compensation must be approved by the service provider's Board of Directors or equivalent governing body, including at least two independent directors or voting members, after a review of comparability data. Further guidance is necessary as to whether an authorized Committee of the Board (as is often used in connection with Intermediate Sanctions and other compensation requirements)

will satisfy the requirements.

Executive compensation under the proposed regulations includes direct and indirect payments of cash, non-cash compensation and benefits, but excludes health insurance premiums and pension contributions if they are consistent with those made on behalf of employees who are not covered executives. Moreover, mandated benefits, such as Social Security benefits, workers' compensation, and unemployment and disability insurance, also are excluded. This definition is different than that used for Form 990.

There is no mention of grandfathering of commitments under existing contracts, which may prove troublesome to entities that have executives on contract but do not meet the above requirements.

Will Agencies Waive Any Limitations Imposed by These Regulations?

Upon a showing of good cause, the relevant agency may, in connection with the Division of the Budget, grant waivers of both the limitations on administrative expenses and on executive compensation.

The proposed regulations contain a number of factors to be considered when evaluating waiver applications. These factors include:

- The nature, size and complexity of the service provider's operations;
- Probable effects on program services if a waiver is not granted;
- Efforts to monitor and control administrative expenses or to secure a comparable executive at a lower level of compensation;
- Efforts to find other sources of funding for administrative expenses;

- Comparability of executive compensation to compensation levels at similarly situated organizations; and

- The service provider's review and approval process for executive compensation.

Waivers will remain in effect for a defined period of time, unless revoked by the agency due to an executive compensation increase of more than 5% a year, or due to "additional relevant circumstances" which have yet to be clarified.

What Are the Reporting Obligations?

The proposed regulations require service providers to issue reports annually or upon a request by the relevant agency. While the agencies have not enumerated any specific disclosure requirements, a press release issued by Governor Cuomo indicated that reporting may be done via a state-wide electronic form which will be made available to service providers.

Probable disclosure requirements include:

- State funds and state-authorized payments received by a service provider;

- Compensation paid to a service provider's executives and highest paid employees; and

- A service provider's expenses for administration and program services.

How Will the Proposed Regulations Be Enforced?

A service provider will have an opportunity to resolve any compliance issues before penalties or sanctions are imposed. Under the proposed regulations, a service provider will first receive notice of apparent noncompliance and will have 15 days to provide additional information. The relevant agency will then determine if the service provider is, in fact, in noncompliance with the regulation. After receiving notice of a noncompliance determination, the service provider will have 15 days to submit a corrective action plan, and at least six months to correct the violation.

If the service provider fails to complete the corrective action program, the relevant agency may either modify the corrective action program or impose sanctions. Possible sanctions include: the redirection of state funds or state-authorized payments; the suspension, modification, limitation or revocation of a provider's licenses; the suspension, modification or termination of government contracts or agreements with a service provider; and any other lawful actions or penalties deemed appropriate.

As New York's proposed regulations are among the first in the country to address these issues, the development, clarification and operation of the proposed regulations will be observed with interest by states and agencies around the country.

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