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Revised Proposed New York Regulations Limit Use of State Funds for Administration Expenses and Executive Compensation by Service Providers as of April 1, 2013

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Implementing Executive Order 38 issued by Governor Cuomo early in 2012, thirteen New York State agencies have now released revised proposed regulations 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 scheduled to become effective on April 1, 2013 (extended from the original date of January 1, 2013; it is widely believed that the effective date will be further delayed). These regulations were previously issued in proposed form and modified in response to public comments but are not final. The revised regulations apply to far fewer entities than initially proposed, but compliance remains a substantial challenge, as many key concepts remain undeveloped or largely subjective.

Subject organizations should begin to prepare for compliance. In particular, systems with several organizations should determine which entities are covered service providers; existing employment agreements should be reviewed to see if they are "grandfathered" until 2014; and both past and future compensation approval procedures should be reviewed for compliance with the regulations' requirements.

Summary of Key Changes from Initially Proposed Regulations

- The regulations have clarified that Medicaid payments (both state and federal portions) and Medicaid managed care payments are state-authorized payments.
- The Department of Health, in its version of the regulations, has specified that numerous types of health care organizations (including hospitals, nursing homes, home care agencies, ambulance services, and assisted living facilities) are covered service providers if they meet certain criteria.

- Individuals providing professional services, entities primarily providing professional services, and providers of products (as opposed to services) are not covered.
- The definition of "related" organizations has been simplified to conform to the definition used in the IRS Form 990 filed by tax-exempt organizations. The definition of "covered executive" also was rewritten to reflect and refer to terms used in Form 990, Part VII.

What Service Providers Are Affected?

The regulations to be are issued by thirteen different state agencies that fund or administer programs. These include, for example, the Department of Health, the Office for the Aging, and the Office of Victim Services. In all cases, they 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. The regulations have clarified that Medicaid payments (both state and federal portions) and Medicaid managed care payments are state-authorized payments. In addition, the Department of Health specifies that numerous types of health care organizations, such as hospitals, nursing homes, home care agencies, ambulance services, and assisted living facilities, among others, are covered service providers if they meet the two criteria in the next paragraph.

Generally, a service provider is subject to the regulations if it has an agreement with an agency or governmental entity to receive state funds or state-authorized payments for program services averaging over $500,000 a year for at least the past two years. Additionally, state funds or state-authorized payments must constitute at least 30% of a service provider's annual in-state revenues for the prior year. Certain payments are excluded from the state funds 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. Notably, a provision in the initially proposed regulations that swept any payments received while operating under a state license into state funds was eliminated in the revised regulations; this broad definition could have caused all licensed providers to be covered. The revised regulations also clarify that individuals providing professional services, entities primarily providing professional services, and providers of products (as opposed to services) are not covered.

The revised regulations provide that organizations "related" to service providers are not themselves covered or counted unless they meet the state funding tests on their own or, for purposes of compensation limits, receive state funds from the service provider. For example, a subsidiary of a covered service provider would not itself be subject to these regulations, unless the subsidiary either (1) met the state funding test on its own or (2) received covered funds from its covered provider-related company. Further, instead of providing a separate definition of what relationships create a "related" organization, the regulations adopt the definition of "related" organization used in the IRS Form 990, filed by tax-exempt organizations. This simplifies compliance to some degree because tax-exempt organizations must list related organizations on Form 990 so the potential group of organizations to be considered is already defined.

What Are the Limitations Regarding Administrative Expenses?

The 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 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 regulations specifically exclude capital expenses, property rental or maintenance, mortgage expenses, equipment rental, and depreciation and interest expenses, as well as nonrecurring or unanticipated expenses (such as unanticipated litigation). On the other hand, quality assurance, electronic health record and appropriate outreach expenses are considered program services-related.

Service providers must ensure contractually that unrelated subcontractors and agents abide by the regulations if the subcontractors or agents would have qualified as service providers had they received the funds directly. In addition, 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 also is 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. Disclosure forms have not yet been released.

What Are the Limitations Regarding Executive Compensation?

The regulations prohibit the use of more than $199,000 of state funds or state-authorized payments to compensate a "covered executive." The definition of "covered executive" was rewritten during the public comment period to reflect and refer to the terms used in Form 990, Part VII. Thus, "covered executive" includes directors, trustees, managing partners, officers and key employees, all as defined in Form 990 instructions (except that the number of key employees is limited to 10 rather than 20) whose compensation in whole or in part is an administrative expense. Again, this makes the group of "covered executives" an organization must consider easier to define because they are already listed on the Form 990. The regulations clarify that individuals such as department chairs and chief medical officers are not "covered executives" if they fulfill administrative functions that comprise program services.

This limitation on compensation for "covered executives" applies to covered executives of service providers as well as to covered executives of a related organization with which a service provider contracts for administrative or program services if at least 30 percent of that executive's compensation is derived from state funding from the service provider.

If a service provider has other sources of funding in addition to state funds, it may provide an executive more than $199,000 in compensation, provided both of the following conditions are met (or, as discussed in the next section, a waiver is obtained):

- 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 approved for use, creating substantial uncertainty, particularly for mixed purpose entities (Medicaid Managed Care/SNF, etc.); and
- The executive's compensation has been 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, and this consideration is contemporaneously documented. This requirement is similar to the "rebuttable presumption of reasonableness" requirements under federal tax exemption intermediate sanctions law. The regulations remain unclear as to whether a compensation committee of the service provider's Board of Directors may grant such approval, but we understand that the State has indicated, informally, that use of a compensation committee permissible under the Intermediate Sanction regulations would satisfy this requirement.

Executive compensation under the regulations includes direct and indirect payments of cash, non cash compensation and benefits reportable on a W-2 form, 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.

Compensation commitments under existing agreements in place prior to April 1, 2012 are "grandfathered" during the term of the agreement (excluding renewals), but not those later than April 1, 2014.

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 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. Waivers must be sought at least 90 days before the compensation commitment, which of course is inconsistent with an April 1, 2013 effective date.

What Are the Reporting Obligations?

The 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. While the regulations make reference to such form, the form has not yet been released.

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.

The regulations clarify that disclosures will not be available publicly unless already required by other authority.

How Will the Regulations Be Enforced?

Enforcement under the proposed regulations will be gradual. A service provider will have an opportunity to resolve any compliance issues before penalties or sanctions are imposed. Under the regulations, a service provider will first receive notice of apparent noncompliance and will have 30 calendar 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 30 calendar 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.

Conclusion

As New York's regulations are among the first in the country to address these issues, the operation of the proposed regulations will be observed with interest by states and agencies around the country. Provider and Bar groups have submitted comments, and legal challenges to the constitutionality of the regulations have been discussed. Nevertheless, pending such litigation and its outcome, and the approval of compensation surveys, issuance of disclosure forms, and other steps that still must be taken for implementation, affected organizations should review their past and present compensation practices, identify potential covered executives, identify potential related service providers, and identify "grandfathered" compensation arrangements now, so that they will be ready when the regulations take effect.

Related Professionals

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