Proskauer

New York State Agencies Again Revise Proposed Regulations Limiting Use of State Funds for Administrative Expenses and Executive Compensation by Service Providers as of July 1, 2013

April 8, 2013

Implementing Executive Order 38 issued by Governor Cuomo early in 2012, thirteen New York State agencies have again 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 were previously released in proposed form and modified in response to public comments in May and October of 2012. The third version of the proposed regulations was published in March 2013 and is open to public comment until April 12. They are written with an effective date of July 1, 2013. At the same time, the agencies issued responses to the public comments to the prior proposed regulations that were intended to clarify government positions.

As we discussed in our alert on the previous proposed regulations, subject organizations should begin to prepare for compliance. This alert outlines the most recent changes to these regulations.

Summary of Key Changes from October 2012 Proposed Regulations

- Although the regulations are scheduled to go into effect on July 1, limits on administrative expenses and executive compensation are not effective until the "first day of each provider's respective reporting period." Thereafter, the reporting period is defined at either the calendar year or the fiscal year used by the covered provider for financial-reporting purposes, at the provider's option, unless the provider files an annual cost report with the state.

- The definition of "executive compensation" has been broadened to include distributions to shareholders or partners when such distributions represent

compensatory or guaranteed payments.

- The definition of "administrative expenses" and "program services expenses" now exclude "that portion of the salaries and benefits of staff performing policy development or research," which will result in expenses qualifying as such to not count toward a covered provider's maximum allowable expenditures on administrative expenses.

- Although the limits on administrative expenses and executive compensation still apply to subcontractors and agents of covered providers to the extent that they received state funds, the revised regulations expressly state that a covered provider "shall not be held responsible for a subcontractor's or agent's failure to comply with these regulations." A covered provider must incorporate the regulations by reference in their agreements with subcontractors and agents.

- The guidance raises concern whether a committee of a covered provider's Board of Directors may approve compensation in excess of the $199,000 limit, under the exception carved out for those covered providers that have other sources of funding in addition to state funds, or if review and approval of the entire Board is necessary.

Effective Date and Reporting Obligations

Although previously set to go into effect on April 1, 2013, the revised regulations have an effective date of July 1, 2013. The covered provider's reporting period is defined as, at the provider's option, either the calendar year or the fiscal year used by the provider for financial-reporting purposes, but entities that are required to file an annual cost report with the state must use the reporting period applicable to the cost report.

Covered entities must electronically file an "EO#38 Disclosure Form" with the state no later than 180 calendar days following the conclusion of the covered reporting period. For a covered provider with a calendar year reporting period, the first covered reporting period would be calendar year 2014, and the covered provider would be required to file the EO#38 Disclosure Form no later than 180 days after December 31, 2014.

While the regulations make reference to the EO#38 Disclosure Form, the form itself has not yet been released.

Broader Definition of "Executive Compensation" for For-Profit Entities

Executive compensation under the regulations includes direct and indirect payments of cash, non-cash compensation and benefits reportable on a W-2 form. The revised regulations broaden the definition of executive compensation to include distributions to a shareholder or partner from the entity's earnings, when such distributions represent compensatory or guaranteed payments, compensatory partnership profits, or compensatory partnership equity interests for services rendered.

Narrower Definition of "Administrative Expenses" and "Program Services Expenses"

The regulations apply to certain providers of "program services," which are defined as services that are paid for, in whole or in part, with state funds or state-authorized payments, and are rendered to and for the benefit of members of the public. "Administrative expenses" 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 compensation of staff members who are not directly involved in providing program services. The regulations enumerate specific expenses that do not fall under the definitions of "program services expenses" or "administrative expenses," and the March 2013 revisions specifically state that "that portion of the salaries and benefits of staff performing policy development or research" does not fall under either definition.

No Liability for a Subcontractor's Agent's Noncompliance

Covered providers must ensure that subcontractors or agents that receive state funds or state-authorized payments abide by the regulations if the subcontractors or agents would have qualified as covered providers had they received the funds directly. Upon request, the service provider is required to report the identity of the subcontractor or agent, along with any other information requested, to the authorizing agency. Further, covered providers are required to incorporate into their agreements with such subcontractors or agents the terms of the regulations' limits on administrative expenses and executive compensation.

While the failure to abide with the foregoing would appear to subject the covered provider to liability, the March 2013 revisions specifically state that a covered provider shall not be held responsible for a subcontractor's or agent's failure to comply with the regulations. It is not clear if this applies when the covered provider has failed to reference the regulations in its subcontract.

Board of Director "Involvement" in Executive Compensation Decisions

The regulations prohibit the use of more than $199,000 of state funds or state-authorized payments to compensate a "covered executive" whose compensation in whole or in part is an administrative expense. If a covered provider has sources of funding in addition to state funds, it may provide an executive more than $199,000 in compensation, provided that (1) the executive's compensation is below the top quartile in his or her field, according to a recognized compensation survey and (2) the executive's compensation has been "reviewed and approved" by the covered provider's Board of Directors.

It was expected that the State would clarify that approval by a compensation committee of a Board of Directors would be sufficient to satisfy the requirement that the Board of Directors approve executive compensation in excess of $199,000, which is consistent with IRS guidance on intermediate sanctions, permitted by New York State law, and in line with common current practices. The Department of Health's responses to the comments in the March 2013 revisions, however, specifically note that the Board's "involvement" is required, while the Office for People with Developmental Disabilities (OPWDD) states that "it is appropriate that the ultimate review and approval of executive compensation be at the level of the Board of Directors." IRS intermediate sanction regulations have been interpreted to permit either the Board of Directors or a committee thereof (if permitted by state law) to make determinations of reasonableness of compensation based on a review of compensation comparability data. The IRS requires, however, that the entity that makes this determination also be the entity that reviews such comparability data. If, under New York regulations, the Board of Directors must make the determination of reasonableness, it must also engage in the lengthy and timely review of comparability data in order to comply with IRS regulations.

This matter is still in flux. It is also important to note that the various state agencies differ slightly on the requirement that the Board of Directors review and approve executive compensation. For example, in addition to the Department of Health and OPWDD positions outlined above, the Office of Mental Health uses language similar to OPWDD, stating that "it is appropriate that the required review and approval of executive compensation be at the level of the Board of Directors," while the Office of Homes and Community Renewal merely states that the issue "will be addressed further in the implementation process."

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 must now begin taking necessary steps for compliance. Such steps are outlined in more detail in Proskauer's past client alerts on these regulations, New York State Agencies Issue Proposed Regulations and Revised Proposed New York Regulations Limit Use Of State Funds.

Related Professionals

- **Edward S. Kornreich**