New York Regulations Limiting the Use of State Funds for Administrative Expenses and Executive Compensation Go Into Effect

August 14, 2013

Implementing Executive Order 38, which was issued by Governor Andrew Cuomo early last year, thirteen New York State agencies have released final regulations placing limits on state 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 went into effect on July 1, 2013.

Read our earlier alerts on previous versions of the proposed regulations, issued in May 2012, October 2012, and March 2013. This alert provides a brief overview of the rules and outlines the final changes to the regulations.

What Service Providers are Affected?

Thirteen different state agencies, including, for example, the Department of Health, the Office for the Aging, and the Office of Victim Services, have issued nearly identical versions of the regulations. In all cases, the regulations apply to certain providers of "program services," which are defined as services rendered by a covered entity or its agent directly to and for the benefit of members of the public and are paid for, in whole or in part, with state funds or state-authorized payments. Generally, a provider of program services is subject to the regulations if it receives state funds or state-authorized payments for program services averaging over $500,000 a year for at least the past two years. Furthermore, state funds or state-authorized payments must constitute at least 30% of a service provider's annual in-state revenues for the prior year. Medicaid payments (both state and federal portions) and Medicaid managed care payments qualify as state-authorized payments.

The limits on administrative expenses and executive compensation apply to subcontractors and agents of covered providers, to the extent that such subcontractors receive state funds from the service provider to provide program or administrative services, and would otherwise be subject to the regulations if it had received such funds directly from the government. Upon request, covered providers are required to report the identity of such subcontractors or agents, along with any other requested information, to the authorizing agency, and must incorporate into their agreements with subcontractors or agents the terms of the regulations' limits on administrative expenses and executive compensation. The regulations, however, now state that a covered provider "shall not be held responsible for a subcontractor's or agent's failure to comply with these regulations."

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," which is defined as having the same meaning of IRS Form 990, Part VII. Thus, a "covered executive" includes directors, trustees, managing partners, officers and key employees, all as defined in the Form 990 instructions, whose compensation in whole or in part is an administrative expense. This limitation on compensation for "covered executives" applies to covered executives of service providers as well as covered executives of a related organization with which a service provider contracts for administrative program services, if at least 30 percent of that executive's compensation is derived from state funding from the service provider.

"Executive compensation" includes all forms of cash and noncash payments or benefits given directly or indirectly to a covered executive. The definition of "executive compensation" was broadened in the March 2013 version of the regulations to include distributions to shareholders or partners when such distributions represent "compensatory or guaranteed payments."

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 (1) the executive's total compensation is below the top quartile in his or her field, according to a compensation survey; and (2) 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 the comparability data. Regarding the latter requirement, the regulations now clarify that a "duly authorized compensation committee" may review such comparability data on behalf of the Board. This is consistent with IRS guidance on intermediate sanctions, which permit such use of a compensation committee. Guidance on the regulations, however, even when such compensation committees are used to review comparability data, "review and approval of the Executive Compensation provided to a Covered Executive must be reviewed and ratified by the board of directors or equivalent governing body." The guidance also sets out several factors that must be included in the Board or compensation committee's review of comparability data.

Compensation commitments under existing agreements in place prior to July 1, 2012 are "grandfathered" during the term of the agreement (excluding renewals), but such agreements may not extend beyond April 1, 2015.

What Are the Limitations Regarding Administrative Expenses?

The regulations require a service provider to use at least 75 percent of 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 per year, until it reaches 85 percent in 2015. "Administrative expenses" are a service provider's management and overhead expenses that are not directly attributable to program services and include, for example, most legal and office operating expenses, as well as compensation of those staff members not directly involved in providing program services. The regulations enumerate specific exclusions to the definition of "administrative expenses," including (1) capital expenses for the purchase, development, and maintenance of real property; (2) property rental or mortgage expenses; (3) taxes; (4) equipment rental; (5) non-recurring unanticipated expenses (e.g., litigation-related legal fees); and (6) that portion of the salaries and benefits of staff performing policy development or research.

It is worth noting that the limits on administrative expenses apply only to state funds and state-authorized payments. To the extent that a covered entity has other sources of funding, these regulations do not apply to those funds. In all likelihood, many covered entities, such as hospitals, will always have other sources of funding to cover costs that exceed the limits on administrative expenses imposed by these regulations.

What are the Reporting Obligations?

Although the regulations went into effect on July 1, 2013, service providers need not file the "EO#38 Disclosure Form" with the state until 180 calendar days following the conclusion of the provider's covered reporting period. The covered 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. For example, for a covered provider with a calendar year reporting period, the first covered reporting period would be calendar year 2014, and the EO#38 Disclosure Form would be due to the state no later than 180 days after December 31, 2014. Note that entities that are required to file an annual cost report with the state must use the reporting period applicable to the cost report.

Conclusion

Affected organizations should prepare for compliance with these regulations by reviewing their past and present practices, identifying potential covered executives, identifying potential related service providers, and identifying "grandfathered" compensation arrangements now. New York State has developed a website for Executive Order 38, which offers information on waivers and compliance.

Related Professionals

- **Edward S. Kornreich**