APRIL 2012

EXECUTIVE SUMMARY

BUSINESS LAW AND GOVERNANCE PRACTICE GROUP

New Limits on Compensation Paid to Executives of State Service Providers

Susan F. Zinder, Esquire*
LeClairRyan
New York, NY

Introduction

On January 18, 2012, New York Governor Andrew Cuomo (D) signed Executive Order No. 38, "Limits on State-Funded Administrative Costs & Executive Compensation" (Executive Order). Under its terms, New York will not reimburse a provider of services to New York state[1] for the compensation of an executive of the provider that exceeds $199,000 and also will not reimburse the provider for administrative costs that exceed 25% of the amounts otherwise payable to the provider by the state.[2] Amounts in excess of these caps will be ineligible for reimbursement as a result of a service provider's participation in a program or contract with New York state. The impact of the Executive Order is potentially broad, affecting within New York state, hospitals, social service agencies and their executives, and serving as a national precedent for states seeking to hold down their Medicaid and other budgetary costs. Given the high profile of New York, as well as of its governor, and that New York has one of the largest Medicaid programs in the nation, the Executive Order can be expected to have potentially precedential effect throughout the nation as states struggle to reign in their budgets. This article will focus on the cap on an executive's compensation.

Although a source of major focus within the New York healthcare industry, the Executive Order's application is *not* limited to the healthcare industry. According

[1] Service providers will be affected by the Executive Order whether they provide the services to New York directly or indirectly.
[2] The percentage will decrease so that by April 2015 it will be no more than 15%.

to its background statements, the Executive Order applies broadly to "tax-exempt organizations *and* for-profit entities that provide critical services to New Yorkers in need." The Executive Order contains language that may provide some potential flexibility in its application, as well as a waiver of its requirements, however, the extent of any flexibility is unknown at this time. Moreover, while various state agencies whose service providers will be impacted are required to develop regulations within ninety days, there is no guarantee they will develop consistent regulations, creating additional uncertainty for providers.[3]

As a result, the Executive Order is expected to significantly impact state service providers either through the cap itself, or through the efforts of organizations to: (1) have the Executive Order's application to them recognized as impracticable; or (2) obtain a waiver of its requirements. Organizations will need to implement ongoing compliance efforts to comply either with its terms or those of any waiver. Given the significant fiscal pressures facing states nationwide, the Executive Order may be the first of similar caps implemented across the country.

Executive Order No. 38

The Executive Order states that:

- *No less than* (emphasis added) 75% of the state financial assistance or state-authorized payments to a provider for operating expenses shall be directed to provide direct care or services rather than to support administrative costs . . . This percentage shall increase by 5% each year until it shall, no later than April 1, 2015, remain at less than 85% thereafter.

[3] For those organizations that provide multiple sets of services regulated by differing state agencies, compliance with one agency's requirements may not assure compliance with all applicable regulation if the regulations are not consistently promulgated.

- *To the extent practicable* (emphasis added), reimbursement with state financial assistance or state-authorized payments shall not be provided for compensation paid or given to any executive by such provider in an amount greater than $199,000 per annum, *provided, however* (emphasis added), that the commissioner of each agency shall have discretion to adjust this figure annually based on appropriate factors and subject to the approval of the Director of the Budget, but in no event shall such figure exceed Level 1 of the federal government's Rates of Basic Pay for Executive Schedule promulgated by the U.S. Office of Personnel Management.[4]

As will be discussed below, exactly what this means is unclear and will remain so at least until the applicable regulations are promulgated, if not beyond. Some flexibility (in addition to identifying what will and will not be "practicable") is expected to be built into the regulations because the affected regulatory agencies are required, when they promulgate their regulations, to include:

> that, under appropriate circumstances and upon a showing of good cause, a provider may be granted a waiver from compliance with these or other related requirements in whole or in part subject to the approval of the applicable State agency *and* (emphasis added) the Director of the Budget.

The extent of the potential waivers, as well as any conditions thereto, and whether or not the various agencies will provide consistent waiver processes is unknown. Regulations to implement the order are to be issued by the various affected state agencies, specifically including, among others, the Department of Health and the Office for People with Developmental Disabilities, within ninety days of the date of the Executive Order (i.e., by April 17, 2012).

[4] It is worth highlighting that the cap is imposed "to the extent practicable" and there is not currently guidance as to the meaning of this language, under which circumstances would it not be practicable, and what would happen as a result.

The regulations will affect all service providers whether they are tax-exempt or for-profit that receive state reimbursement either "directly or indirectly." Failure by a provider to comply with the regulations issued by its regulating agency (and it is possible for a single provider operating under multiple licenses to have to comply with differing regulations issued by different agencies) may result in the provider being terminated from a program or not having its state contract renewed, thereby losing its state support or compensation for that program. Accordingly, the development of the regulations is being closely watched across the state by providers, their attorneys, and other advisors.

Context

Nonprofit hospital and healthcare boards have generally attempted to insulate themselves, and their organizations, from exposure to the legal risks associated with potentially excessive executive compensation through strict adherence to the applicable laws. They have accomplished this by implementing policies and practices intended to obtain the "rebuttable presumption of reasonableness" regarding their decisions to compensate "disqualified persons"[5] under the Intermediate Sanctions Rules associated with Internal Revenue Code Section 4598.[6] These processes include, among other things, involvement of legal

[5] "The term 'disqualified person' means, . . . (A) any person who was, at any time during the [preceding] 5-year period, in a position to exercise substantial influence over the affairs of the organization, (B) a member of the family of an individual described in subparagraph (A), ... " 26 U.S.C. § 4958(f)(1)(A), (B).

[6] According to the IRS: "If an organization meets the following three requirements, payments it makes to a disqualified person under a compensation arrangement are presumed to be reasonable, and a transfer of property or the right to use property is presumed to be at fair market value. The three requirements for establishing the rebuttable presumption are:

1. The compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization, which is composed of individuals who do not have a conflict of interest concerning the transaction,
2. Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability, and
3. The authorized body adequately and timely documented the basis for its determination concurrently with making that determination.

"The documentation of the authorized body should include the terms of the transaction and the date of its approval, the members of the authorized body present during the debate and vote on the transaction, the comparability data obtained and relied upon, the actions of any members of

counsel and recognized compensation consultants to ensure that the governing board understands the reasonableness and comparability of the proposed compensation package in determining the executive's compensation, and appropriately documenting its decisions.

Insulation from reputational risks may be even more challenging to access when entities award large executive compensation packages. Under current Internal Revenue Service (IRS) regulations, all tax-exempt entities must report the compensation of various "disqualified persons," including certain senior executives and physicians, on their annual 990 filing. These filings are publicly disclosed and easily accessible, either through the organizations themselves (which occasionally post the filings on their websites), through www.guidestar.com and other sites, and, at least in New York, through the Charities Bureau of the Office of the New York State Attorney General. While the filings have been publicly available for some time, the annual 990 filings are increasingly the focus of attention of not only the federal and state governments, and the plaintiff's bar, but the press and the local community.

As a result, it is possible that carefully made decisions based upon the best legal, financial, and compensation advice will not insulate an organization from risks that will result from issuing large paychecks to senior executives that must be publicly disclosed, even if the compensation is decided upon through policies consistent with applicable regulations and would be considered appropriate by the executive, the board, and the industry. This is particularly true during a period

---

the authorized body having a conflict of interest, and documentation of the basis for the determination.
"The Internal Revenue Service may refute the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body." *available at* www.irs.gov/charities/charitable/article/0,,id=173697,00.html

of transparency that corresponds with a post-recessionary era where state governments are challenged to reduce their budgets.[7]

The stated purpose of the Executive Order is "to curb . . . abuses in executive compensation and administrative costs and ensure that taxpayer dollars are used first and foremost to help New Yorkers in need." However, it is not targeted at abuse, but rather focused upon a chosen dollar amount. Although reflective of the national (and indeed international) concerns about executive compensation associated with Wall Street salaries, bonuses, and the recent recession,[8] the Executive Order reflects the governor's response to various disclosures and reports regarding compensation provided to executives of nonprofit healthcare and social services providers in New York state.[9]

---

[7] Compensation to a variety of executives and employees must be disclosed on the exempt organization's annual 990 filing, and these filings are public and receiving increasing attention and scrutiny from the press as the nation comes to grips with the public nature of the filings. *See below*.

[8] *See e.g.,* Steven M. Davidoff, *Efforts to Rein in Executive Pay Meet with Little Success*, The New York Times DealB%k, July 12, 2011 ('[M]edian compensation for chief executives at 200 large companies [reflected] a 26% increase from" 2009 to $10.8 million per annum. Executive compensation rose 300% between 1992 and 2007.'); Mary Williams Walsh, *U.S. Faulted Over Pay at Rescued Firms*, The New York Times, January 24, 2012 ("Federal auditors said that the government failed to rein in executive compensation at the biggest companies it bailed out during the financial crisis because its main concern was simply getting its money back."); Julia Werdigier *In Britain, Rising Outcry Over Executive Pay that Makes 'People's Blood Boil'*, The New York Times, January 22, 2012 ("Over the last two months, two of the country's biggest investors stepped forward to declare their general disapproval with the level of executive pay, and to call for investors to be given more say of the packages. Prime Minister David Cameron backed their calls on Thursday after saying that large pay packages, during times when many households have to tighten their belts, understandably 'made people's blood boil'."); Julia Werdigier, *British Government Looks to Rein in Executive Pay*, The New York Times DealB%k, January 23, 2012, (The British government's business secretary proposed a four point plan to "revamp corporate pay practices and make compensation more transparent" including a proposal that "shareholder votes on executive pay would be binding."). National focus has also been given to hospital executive compensation in particular. In 2009 Congressman Waxman and Stupak (in a bipartisan effort) surveyed various hospitals nationwide as to their executive compensation practices. On June 30, 2006, the U.S. Government Accountability Office (GAO) issued a report to the House Ways and Means Chair entitled *"Nonprofit Hospitals Systems: Survey on Executive Compensation Policies and Practices."* The GAO report noted, among other things, that the hospitals whose data was reflected in its report commonly have a review of executive compensation by a board level committee or by the complete board, they have conflicts of interest policies that cover members of the compensation committee and any compensation consultant, and they rely upon comparable market data in setting their compensation structures.

[9] *See e.g.,* Barbara Benson, *Hospital Execs Enjoy Healthy Paydays*, Crain's New York, March 21, 2010 (During 2008 "the 21 top-earning hospital executives . . . collectively earned $64.3 million."),

As recently as this month, Crain's New York, and its healthcare-focused news-daily Crain's HealthPulse, published Crain's annual report on hospital executive compensation. Specifically, on March 19, 2012, Crain's published its annual list of the "Top Paid Hospital Executives and Employees," detailing the 2010 compensation of the twenty-five "Top-Paid Hospital Executives," and twenty-five "Top-Paid Hospital Employees" in New York state.[10] The accompanying article noted that a significant contributor to the size of some of the executive compensation packages was the executive's deferred compensation plans or supplemental executive retirement plans (SERPS) which were "a way to reward longevity."[11] The article went on to quote Linda Lampkin, research director at ERI Economic Research Institute, who specifically acknowledged that "running a hospital is a complex business . . . with all sorts of rules and regulations that you need expertise to deal with" but she also observed that this is contrasted with the impression that "[t]he public says people running nonprofits should take a vow of poverty because they are in the business of doing good."[12]

Lindy Washburn, *Severance Raised Hospital Chief's Pay to $7.7 M,* The Record, December 22, 2010, *at* www.NorthJersey.com, *(*The former president of Hackensack University Medical Center received approximately $7.7 million in salary and severance during 2009. The article also noted that the salary and bonuses for the president of the Stevens Institute of Technology had increased from $365,000 during 1999 to approximately $1.1 million during 2008*.)*, *available at* www.Georgiahealthnews.com*, High CEO Pay Common at Hospitals Statewide,* August 31, 2011 ("Concerns over hospital executive pay arose again recently when WellStar Health System's new CEO received a contract including a base salary of $975,000." Wellstar is based in Marietta, GA). *See also*, Jake Pearson, *Health vs. Wealth: Boss of Struggling Brooklyn Hospital Facing Closure, gets $4M salary*, New York Daily News, August 15, 2011 (Dr. Linda Brady, President and CEO of Kingsbrook Jewish Medical Center, was the highest-paid hospital executive during 2009 a year in which Kingsbrook was "forced to close a clinic and lay off workers and staff members took furloughs because of budget tightening."), New York Post, "Rich CEOs Performing Cashectomy on Hospitals," November 27, 2011 ("Despite a struggling health-care industry and a flatlining economy, four hospital CEOs received $1 million-plus bonuses and the president of an ailing Brooklyn hospital cashed out a $3.3 million retirement payment . . . . Such bonuses are expected to be scrutinized by Gov. Cuomo's new task force on nonprofit pay"). In the interests of full disclosure, the author notes that the last two articles and a number of the other articles and reports discussed in this memorandum focused specifically upon the compensation paid to Linda Brady, MD, by Kingsbrook Jewish Medical Center, where I was employed as general counsel between June 2004 and February 2011.

[10] *Top-Paid Hospital Executives, Ranked by 2010 cash compensation; Top-Paid Hospital Employees Ranked by 2010 cash compensation,* Crain's New York, March 19, 2012, p. 18.

[11] Barbara Benson, *SERPS up! Hospital execs win big*, Crain's New York, March 19, 2012, p. 3.

[12] *Id*., p. 24.

During 2011, and in response to efforts by the New York hospital industry to pass medical malpractice reform as part of Medicaid reform, the Center for Justice and Democracy (CJD)[13] took up the banner of executive compensation limits with its own report, issued on March 22, 2011, on hospital executive compensation.[14] Prior to the issuance of CJD's report, Cuomo had formed a "Medicaid Redesign Team" (MRT) which was tasked with reviewing proposals and developing ideas that would reduce the cost of Medicaid within the state while increasing the quality of care provided to Medicaid patients, and that was composed of a number of people including industry insiders. A $250,000 cap on "non-economic" damages in medical malpractice liability suits was among the proposals that had been submitted by the hospital industry and was then under consideration by the MRT. In response to this, CJD submitted its own proposal to the MRT to allow public financing for only up to $1 million in executive compensation. When CJD believed that its proposal was not even considered by the MRT, it issued its report which proposed a $250,000 cap on hospital executive compensation.

The report, entitled "Saving Medicaid $213 Million by Capping Hospital Salaries, Not Patient Rights," included a detailed listing of 658 New York hospital executives whose 2009 annual compensation exceeded $250,000 (i.e., the amount of the proposed cap on non-economic medical malpractice damages). Indeed, more than forty individuals were disclosed in CJD's report as receiving compensation during 2009 in excess of $1 million.[15] CJD particularly noted that although leading academic medical centers (which presumably were financially stable) were among those that paid compensation in excess of $1 million, a

[13] The Center for Justice and Democracy is based out of New York Law School. According to its website, the Center was founded by "consumer advocates to . . . protect our civil justice system."
[14] Center for Justice and Democracy, *Saving Medicaid $213 Million by Capping Hospital Salaries, Not Patients' Rights*, March 22, 2011.
[15] As with the Crain's reports, the information was obtained from the Center's review of the public 990 filings of the various hospitals.

number of smaller community hospitals (including ones that were financially struggling) did so as well.[16]

While concern over executive compensation in nonprofit service providers has arisen in New York, given the prevalence of large compensation packages throughout healthcare nationwide, as well as the pressures on state budgets, the issue is not limited to New York. In July 2011, the office of the Massachusetts Attorney General (AG) issued a report regarding the compensation and severance package provided to a former chief executive officer of Blue Cross and Blue Shield of Massachusetts (BC/BS-M). The report was completed under the AG's authority to "enforce the due application of funds given or appropriated to public charities within the commonwealth and prevent breaches of trust in the administration thereof."[17] While acknowledging that the BC/BS-M board had engaged outside counsel and compensation consultants who advised the board that "severance protections, such as that, ultimately given to the [former CEO], were standard and expected within the relevant market," the report was highly critical of the more than $4 million severance package given to the former CEO by the board.[18] Soon thereafter, BC/BS-M rebated an amount equal to that of the severance package to BC/BS-M premium payors. There is speculation that this

[16] In light of the Executive Order, it is worth emphasizing that the 658 individualswhose 2009 compensation was reported in the Center's report cannot be considered to be the only hospital executives or employees in New York whose compensation exceeded $250,000 (and thus would come under the potential impact of the Executive Order). The 658 were only those individuals whose positions and compensation within the various institutions were understood by the institutions to require disclosure on the IRS form 990s. Undoubtedly, many individuals whose compensation exceeded the thresholds of both the Center and the Executive Order were not listed, because their positions within their organizations presumably did not qualify them as one of the individuals whose compensation required disclosure. Accordingly, the potential reach of the Executive Order is well beyond the 658 identified individuals.

[17] It is interesting that the Attorney General's office made a point of stating that the general counsel and outside counsel of BC/BS-M had been interviewed in the development of the report.

[18] *Available at* www.mass.gov/ago/docs/nonprofit/bcbs-report-final-7-11.pdf. Although critical of the actual amount paid under the severance package, the report acknowledged that a severance was appropriate under the circumstances and that a severance package of a different level might be appropriate if the circumstances that triggered its payment involved a change in control of BC/BS-M.

rebate was to compensate its policyholders for the significant severance package.

The BC/BS-M case again highlights that in an environment where compensation is required to be disclosed, insulation from IRS sanctions regarding compensation decisions will not insulate either a board or an executive from reputational risks resulting from compensation perceived by the community to be excessive.

In addition to the increased focus that healthcare executive compensation received from the press during 2011 and continues to receive during 2012, compensation paid to executives of social service providers was also the subject of discussion in New York during the summer of 2011 and appears to have been an additional contributor to Cuomo's proposal to cap executive compensation of state service providers. On August 2, 2011, the *New York Times* published a scathing article by Russ Buettner, "Reaping Millions in Nonprofit Care for the Disabled."[19] The article focused on the compensation practices of the Young Adult Institute Network (YAI), which operates a number of group homes for the developmentally disabled within New York. The article alleged, among other things, that YAI inflated its costs, paid each of four of its executives in excess of $500,000, and paid for certain expenses for its executives and their family members including a co-op apartment for the daughter of a senior executive.

Response to the article was not limited to public outcry or to YAI's board's overhaul of various of its practices.[20] The day after the article was published, Cuomo announced the creation of a task force to review "executive compensation at nonprofit organizations that receive taxpayer subsidies from the

[19] Russ Buettner, "Reaping Millions in Nonprofit Care for the Disabled," The New York Times, August 2, 2011.
[20] Barbara Benson, Gale Scott, *YAI Overhauls Board and Executive Compensation*, Crain's HealthPulse, September 12, 2011.

state."[21] The Executive Order followed from the efforts of that state task force, as well as those of the MRT, to reduce Medicaid costs. Indeed, among the efforts of the MRT was a November 28, 2011, report which contained proposals to redesign healthcare delivery within Brooklyn.[22] The Brooklyn market is particularly Medicaid reliant, and partially as a result, particularly fiscally challenged and a source of focus for the New York State Department of Health. Even so, a number of hospital executives within the Borough were identified in both the CJD report, as well as the Crain's report of the twenty-five top-paid hospital executives (both during 2011 and 2012). The cap was announced around the time of the governor's State of the State address and was among the initiatives proposed by the governor for the state fiscal year 2012-2013 budget. Given the proportion of Medicaid expenditures to the rest of the budget, the state must address and try to rein in Medicaid spending.[23]

Into the Future

The impact of the Executive Order within New York is unknown, but it will be broad, affecting service providers within and outside the healthcare industry and reaching for-profit as well as nonprofit providers. It can be expected that as

---

[21] Russ Buettner, *State Panel to Review Pay of Leaders at Nonprofits*, The New York Times, August 3, 2011.

[22] Brooklyn is known within New York to be an unusually challenged marketplace for healthcare providers given that its population is medically underserved, confronted by many chronic diseases including an epidemic of diabetes, maintains a comparatively high average length of stay as compared with that of the nation, and is substantially reliant upon Medicaid and Medicare funding. In addition, because of the immigrant nature of the population, many individuals do not qualify for public assistance. As a result of the borough's over-reliance on Medicaid reimbursement, many of its facilities struggle financially. Accordingly, the state's Medicaid Redesign Team recently issued a report that called for, among other things, the closure and merger of various facilities. Nonetheless, it is worth noting that many executives with Brooklyn hospitals were identified in the CJD report. The MRT report is *available at* www.health.ny.gov/health_care/medicaid/redesign/docs/brooklyn_mrt_final_report.

[23] John Eligon, *Cuomo Limits State Money for Salaries of Contractors*, The New York Times, January 19, 2012; Chuck Bennett, *Clampdown on Nonprofit Pay*, The New York Post, January 20, 2012. Additional healthcare related proposed budget provisions include allowing the New York State Department of Health to remove hospital executives and board members in failing institutions. *Cuomo Releases New York State Budget*, Skyline News, January 23, 2012. Skyline News is a publication of the Greater New York Hospital Association, one of two hospital trade associations within the state.

states across the country struggle with their own budgetary considerations and efforts to reduce Medicaid spending, the response to the cap and its implementation will be closely watched nationally for potential local adoption. While putting aside the amount of any individual's compensation, the imposition of the cap will place nonprofit entities in a quandary of following the advice of their legal counsel and compensation consultants, establishing an executive's compensation as reasonable under IRS regulations (and market conditions), and possibly ending up with compensation that is inconsistent with the cap imposed by the Executive Order. How an institution will handle that, and find the funds necessary to pay the executive's compensation from elsewhere within its revenue cycle, will pose interesting challenges.

Of course, with respect to the Executive Order itself, there is currently a great deal of uncertainty regarding its implementation, including, among other things:

- Assuming that an organization will not be prevented from providing compensation that exceeds the cap *if* the excess is not reimbursed by New York state, how will an entity distinguish in its accounting between reimbursable and non-reimbursable compensation?
- The timing of the regulations, and whether the regulations among the differing agencies will be consistent? Service providers operating under licenses issued by differing agencies with differing regulatory standards will undoubtedly be challenged as to their compliance activities.
- Who are the direct and indirect service providers to be covered by the cap?
- By what standards will "practicability" be determined and a provider able to apply for a waiver to the cap?
- Who will be considered to be executives covered by the cap?

- How will executive recruitment and performance be affected by the Executive Order? Will organizations that are already overly reliant on state reimbursement for a variety of legitimate reasons be placed at a disadvantage in competing for executive talent with organizations that are less reliant on state funding and better capable of applying non-state-generated funds to executive compensation?

While New York has a high profile in regulation of the financial industry, specifically Wall Street, which affects the rest of the country, the policy drivers that have brought about the Executive Order are also present throughout the country, and New York may end up leading on this issue as well—for better or ill—particularly for healthcare institutions and their patients, but also for all other service providers whether they are nonprofit entities, privately held for-profit entities, or even publicly traded institutions.

**Special thanks to Neil Ekblom, Esquire, and Elsie Zecchino of LeClairRyan for their assistance with this Executive Summary.*