New York Law Journal

WWW.NYLJ.COM

An ALM Publication

VOLUME 250—NO. 101

FRIDAY, NOVEMBER 22, 2013

Outside Counsel

Expert Analysis

New York Cracks Down on Executive Compensation for Not-for-Profits

"Executives at not-for-profits should be using the taxpayer dollars they receive to help New Yorkers, not to line their own pockets… There is a whole range of compensation levels and extremes that have existed for too long…."

By **Andrew B. Roth** And **Kimberly J. Gold**

Those powerful words were spoken by New York Governor Andrew M. Cuomo just over two years ago in his announcement of the formation of a task force to combat excessive executive compensation at not-for-profit corporations that provide services to the poor.[1] The creation of the task force marked the beginning of major efforts that would culminate in new regulations governing executive compensation of certain New York not-for-profit health care corporations, and a proposed law applicable to the compensation paid to executives of all New York not-for-profit corporations.

The compensation paid to executives of tax-exempt organizations has been the subject of much recent attention, and has received much criticism, especially in New York. Excessive executive compensation can result in public relations disasters. It also can trigger significant legal ramifications for organizations that are out of compliance with applicable statutory and regulatory requirements, both at the federal and the state level. In this article, we discuss the relevant authorities, and focus on regulations issued by the Department of Health for not-for-profits in the health industry. We then suggest a series of "best practices" for not-for-profit corporations—both in the health industry and other sectors—as they make compensation determinations for their executives.

Sanctions Regulations

Compensation of not-for-profit executives has long been regulated at the federal level. Tax-exempt organizations, including most New York not-for-profit corporations, must comply with Department of the Treasury regulations promulgated pursuant to Section 4958 of the Internal Revenue Code (known as the Intermediate Sanctions Regulations) in order for the compensation paid to their executives to qualify for a "rebuttable presumption of reasonableness" and to avoid characterization, and the attendant penalties, as "excess benefit transactions." Under Section 4958 of the Code, the IRS may impose certain excise taxes on "disqualified persons" who either benefit from or approve an excess benefit transaction.

Many tax-exempt organizations have relied upon the "safe harbor" provisions of the Intermediate Sanctions Regulations, which provide that payments made under a compensation arrangement, including benefits, are presumed to be reasonable, and not an excess benefit transaction, under the following conditions: (1) the compensation arrangement is approved in advance by the independent members of the tax-exempt entity's governing body or other authorized body (usually the board of directors or a board committee); (2) the authorized body "obtained and relied upon appropriate data as to comparability prior to making its determination"; and (3) the authorized body adequately documented the basis for the determination concurrently with making that determination.[2]

Compensation Reform

Unlike federal law, New York law did not address executive compensation of not-for-profit corporations until very recently. Cuomo's task force was prompted by the revelation, appearing first in The New York Times, highlighting the seven-figure compensation packages paid by the Young Adult Institute (YAI) to its two top executives. The

ANDREW B. ROTH *is a member of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo.* KIMBERLY J. GOLD *is a senior associate with the firm. They are in the New York office.*

Times reported that the YAI executives' packages included luxury cars, tuition payments for their children, and a payment of more than $50,000 for the living expenses of the daughter of one of the executives.[3]

The Times article, coupled with years of scrutiny, served as a major catalyst for executive compensation reform. The day after the article ran, Cuomo announced the creation of the task force, following reports of "startlingly excessive salaries," to investigate compensation levels at not-for-profit organizations doing business in the state.

Executive Order No. 38. In January 2012, Cuomo issued Executive Order No. 38, calling upon state agencies to promulgate regulations limiting the executive compensation of New York not-for-profit organizations that receive state funds, such as Medicaid. Since then, 13 New York State agencies, including the Department of Health, passed a series of regulations implementing the executive order.[4]

Health Dept. Regulations

The regulations enacted by the Health Department implementing the governor's executive order[5] state that, effective July 1, 2013, a "covered provider" (i.e., an entity or individual that receives state funds) may not use more than $199,000 per year (the regulatory cap) of state funds or state-authorized payments for compensation, including benefits, paid to a "covered executive," unless the compensation meets the regulatory safe harbor or the covered provider has obtained a waiver from the Health Department. The definition of "covered executive" has the same meaning ascribed to it in the IRS Form 990 (i.e., directors, trustees, officers and key employees).

The safe harbor in the Health Department regulations consists of three elements that are patterned after the intermediate sanctions regulations safe harbor. Safe harbor protection under the DOH regulations will be afforded to executive compensation arrangements that exceed the regulatory cap if: (1) the executive compensation was reviewed and approved by the covered provider's governing board, including at least two independent directors, using appropriate comparability data; (2) the compensation is lower than the 75th percentile of compensation provided to executives of comparable covered providers of the same size, program service sector, and geographic area, as established by a compensation survey identified, provided, or recognized by the Health Department or the director of the Division of Budget; and (3) the foregoing is substantiated with sufficiently detailed contemporaneous documentation.[6]

> Executive Order No. 38 calls upon state agencies to promulgate regulations limiting the executive compensation of New York not-for-profit organizations that receive state funds, such as Medicaid.

The Health Department or the Division of Budget may waive the 75th percentile requirement (or the regulatory cap) upon a showing of "good cause" by the covered provider. In determining whether good cause exists, the two agencies will consider, among other things: (1) the extent to which the executive compensation is comparable to that given to similarly situated executives in other like providers; (2) the nature, size, and complexity of the covered provider's operations and program services; (3) the qualifications and experience of the covered executive; and (4) the provider's efforts, if any, to secure executives with the same levels of experience, expertise, and skills for the positions of covered executives at lower levels of compensation.[7]

Suggested Best Practices

In order to qualify for safe harbor protection under the intermediate sanctions regulations, and under the Health Department regulations if the organization receives state funds for health care activities, not-for-profit corporations should implement policies and procedures that ensure compliance with each of the applicable safe harbor elements.

An executive's compensation arrangement must be approved in advance by independent members of the entity's governing body or a board committee, using appropriate comparability data. Use of a compensation committee of the board of directors that is responsible to evaluate and recommend levels of executive compensation to the full board has come to be considered by attorneys, commentators and advisors to be a "best practice" in this area. The nomenclature, "compensation committee," however, is just a label. The "best practice" is having a committee, by whatever name an organization may give it, that addresses compensation issues and is comprised of individuals with the requisite competence and expertise in financial, accounting and/or compensation matters.

The committee should be composed of independent directors. Individuals who have any interest, direct or indirect, in the compensation process or its outcome should not participate in the committee. Compensation reviews and determinations made by the committee should be conducted outside the presence of involved executives, but the CEO may, if the committee chooses, participate in the deliberations on the compensation of officers other than himself. The committee generally should be small and comprised of financially qualified individuals who have the knowledge and capability to analyze and evaluate independent reports and opinions in making compensation determinations.

For the committee to have appropriate comparability data, it must have sufficient information to determine whether the compensation arrangement is reasonable. The engagement of a reputable independent firm and the use of that firm's compensation surveys would likely satisfy the conditions under both the Intermediate Sanctions Regulations and the Health Department Regulations.

Under the Health Department regulations, one or more of the surveys that the compensation firm relies upon must be "identified, provided, or recognized" by the Health Department or the director of the Division of Budget. As of this writing, neither the Health Department nor the director of the Division of Budget has published guidance identifying any such compensation surveys.

In addition, there is presently no guidance as to what constitutes adequate documentation, but at the very least it should be "in a form and level of detail sufficient to allow" the Health Department to determine whether the entity should or should not be subject to penalties. For example, the board committee should document the rationale for determining the range, the procedures established and followed, and, ultimately, the final compensation for each executive. The documentation should indicate reliance on the independent compensation firm's analysis and should refer to any other materials assembled for the committee's consideration, as well as the procedures established by the committee.

Finally, all of the materials should be retained as records of the corporation, with appropriate restrictions on access due to the sensitivity of the information contained therein. It is sound practice to reflect all of the foregoing in the minutes of the committee meeting at which these matters are considered.

Reform Act

In addition to the regulations applicable to health care organizations receiving state funds, efforts recently were made at the legislative level to broaden executive compensation limits to all New York not-for-profit corporations. The Executive Compensation Reform Act (ECRA), which bears striking similarities to the IRS intermediate sanctions regulations and the Health Department regulations, was introduced in the last legislative session.[8] While ECRA did not make it past the committee level, the bill is an indicator that statutory executive compensation reform may very well be forthcoming, and that such statutory reform may take the same shape and form as ECRA.

ECRA would require that all nonprofit employee compensation be fair, reasonable and commensurate with the services provided to the organization. The board or a compensation committee consisting of independent directors must review the total compensation, including benefits, paid to the principal executive officer to make that determination.

Use of a compensation committee of the board of directors that is responsible to evaluate and recommend levels of executive compensation to the full board has come to be considered by attorneys, commentators and advisors to be a 'best practice' in this area.

For charitable organizations with more than $2 million in annual revenue, compensation to the top five highest compensated "key employees" (meeting the definition of "disqualified persons" under the intermediate sanctions regulations) in excess of $150,000 must also be reviewed to ensure that it is fair, reasonable and commensurate with the services provided to the organization. The compensation determination must consider compensation paid to similarly situated employees, the employee's performance and the organization's financial condition. A person who may benefit from the compensation may not participate in the compensation decision-making process, which must pass by majority vote.

There are many similarities between ECRA and the intermediate sanctions regulations, as well as the Health Department regulations. Like the intermediate sanctions regulations and the Health Department regulations, ECRA, if passed, would require fair and reasonable compensation to executives and a review of comparability data by independent directors to determine reasonableness. This is a clear indication that the state is concerned with some of the same factors underlying the existing federal and state regulations.

If not-for-profit corporations have already implemented appropriate practices to comply with the intermediate sanctions regulations, and the Health Department regulations (if applicable), then compliance with ECRA, if passed, or a similar New York law regulating not-for-profit executive compensation that may be passed in the future, should be relatively painless.

1. Press Release, Andrew M. Cuomo, Governor Cuomo Orders Statewide Review of Executive Compensation at Taxpayer Supported Not-for-Profits (Aug. 3, 2011).

2. 26 C.F.R. §53.4958-6(a).

3. Russ Buettner, "Reaping Millions in Nonprofit Care for Disabled," N.Y. Times, Aug. 2, 2011.

4. Executive Order. No. 38: Limits on State-Funded Administrative Costs & Executive Compensation, Jan. 18, 2012.

5. 10 NYCRR Part 1002.

6. 10 NYCRR §1002.3(b).

7. 10 NYCRR §1002.4.

8. Executive Compensation Reform Act (NY A.7338/S.5197). In the same legislative session, the Non-Profit Revitalization Act of 2013 (NY A.8072/ S.5845), which would be the first major modification to the New York Not-for-Profit Corporation Law (N-PCL) in more than 40 years, was introduced and passed. If signed into law by Cuomo, the changes to the N-PCL will go into effect on July 1, 2014.

Reprinted with permission from the November 22, 2013 edition of the NEW YORK LAW JOURNAL © 2013 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-11-13-36

MINTZ LEVIN
Mintz Levin Cohn Ferris Glovsky and Popeo PC