Senate Standing Committee on Investigations and Government Operations
Executive Compensation at Not-for-Profit Organizations
February 6, 2012

Overview and Introduction:

On behalf of the more than a dozen undersigned associations and coalitions of not-for-profit organizations, we understand and appreciate the concern that has arisen over reports of excessive compensation in organizations—not-for-profit or otherwise—that contract with the State. We believe, however, that more effective and targeted approaches could be taken to address any legitimate concerns over compensation and administrative expenses incurred by certain state contractors than have been advanced in the Executive Budget or in the Executive Order and would urge the Legislature to consider the alternative approaches outlined below to address these issues.

It is important to approach the issues of executive compensation and administrative expenses in not-for-profit organizations with an understanding of the important role played by the not-for-profit sector in New York, the complexity and diversity of these organizations, the already extensive regulation that governs not-for-profit corporations and the potential unintended consequence of new, across-the-board state mandates on these organizations.

We do not dispute that some entities contracting with New York State have abused their trust, departed from their mission and failed to abide by the executive compensation standards and procedures that already apply to tax-exempt not-for-profit organizations. We believe additional steps should be taken by New York State to hold not-for-profit boards and executives accountable for compliance with reasonable compensation policies and to ensure that state support is directed efficiently and cost-effectively to serve the intended beneficiaries of state funding. We respectfully submit, however, that arbitrary, inflexible, across-the-board approaches that purport to redress abuses that are neither widespread nor currently unregulated will penalize honest and ethical not-for-profit organizations and the needy New Yorkers who are the ultimate beneficiaries of their services and could do unintended and irreparable harm to the New York not-for-profit sector.

The role of not-for-profit agencies in New York:

The not-for-profit providers of health and human services that are members of the undersigned organizations have provided essential services to needy New Yorkers for, in some cases, a century or more. They have done so at the express urging of a State government that recognizes that it cannot provide these services nearly as well or as cost-effectively as these mission-driven organizations. Not-for-profit service providers represent a very significant part of the New York State economy, employ more than a million New Yorkers, provide the lion's share of health and human services to all New Yorkers, and, in particular, are irreplaceable elements of New York's safety net for our most vulnerable citizens.

According to a recent report from the Office of the State Comptroller, New York State has nearly 27,000 registered nonprofits and the State has entered into more than 22,000 active

contracts with these organizations to provide critical services to New Yorkers.[1] According to a just released report from the Center for Civil Society Studies at Johns Hopkins University, 1,246,900 New Yorkers are employed by not-for-profit organizations, representing 18.1% of all private sector employees—and, while the for profit sector has actually declined nationally by an annual rate of .6 percent over the past decade, the nonprofit sector has grown by an average of 2.1% per year.[2] Of the top twenty employers in New York State, nine are not-for-profit organizations, four of which number among the State's top ten employers.[3]

A study by the Long Island Association found that not-for-profits accounted for 11.0 percent of total employment on Long Island in 2010 with an annual payroll of $6.4 billion in 2010—and that the 132,640 nonprofit jobs on Long Island generated another 88,500 additional jobs in Nassau and Suffolk Counties, accounting for a total payroll of nearly $11 billion.[4] Independent, non-profit colleges and universities are responsible for generating 174,000 jobs with a payroll exceeding $10.7 billion and contribute $54.3 billion to the State's economy.[5] It was likewise estimated that the early child care and education field accounted for nearly 120,000 jobs and $4.7 billion in economic activity—while enabling 750,000 parents to maintain their employment.[6]

Although the not-for-profit sector has been a vibrant contributor to the State's economic activity, it is also affected by the severe economic downturn: reduced governmental funding at all levels as well as diminished charitable giving have caused considerable financial distress to not-for-profit organizations across the State.

The economic contributions made by the not-for-profit sector in New York are, in any event, only part of the story: without not-for-profit organizations, essential public services—education, health care, and a broad array of other services for disabled, disadvantaged and aging New Yorkers—would either not be provided at all or would be provided by the public sector at substantially greater cost to the taxpayer. Generally speaking, when these services are delivered by the public sector, the overall costs of administration, overhead, salaries and benefits are higher, not lower, than when delivered by not-for-profit organizations. Fringe benefit costs alone for public sector employees are roughly twice what are incurred in the not-for-profit sector. The mission-driven not-for-profit sector has also long been credited, moreover, with providing these services at a level of quality that at least equals, and often exceeds, that of the public sector.

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[1] Office of the New York State Comptroller, *"New York State's Not-for-Profit Sector: Delayed State Contracts and Late Payments Hurt Service Providers,"* November, 2011.

[2] L. Salamon, et al., *"Holding the Fort: Nonprofit Employment During a Decade of Turmoil,"* Johns Hopkins University Center for Civil Society Studies, January, 2012, pp. 3, 5

[3] Center for Governmental Research, *"Economic Impact of the University of Rochester and its Affiliates,"* April, 2010, p. 13.

[4] Long Island Association, *"Long Island's Not-for-Profit Sector: Doing More With Less During a Period of Economic Change*," June, 2011, pp. 6, 10.

[5] Commission on Independent Colleges and Universities, *"Economic Impact of Independent Colleges and Universities in New York State."*

[6] Cornell University Department of City and Regional Planning, *"Investing in New York: An Economic Analysis of the Early Care and Education Sector,"* April, 2004.

In sum, given the role that not-for-profit entities play in New York—both economically and as the principal safety net service provider for our most vulnerable citizens—it is essential that proposals that might negatively impact on the not-for-profit sector be viewed with caution and we would urge this Committee and the Legislature to approach the issue with these consequences in mind.

Existing oversight of executive compensation and administrative costs:

Not-for-profit organizations are already subject to rigorous federal and state oversight that includes regulation of excessive executive compensation and administrative expenses. The Attorney General's Office is authorized by the Not-for-Profit Corporation Law (N-PCL) and the Estates, Powers and Trusts Law (EPTL), as well as by common law, to exercise comprehensive regulatory authority to supervise the operation of the state's not-for-profit corporations, including the reasonableness of compensation.[7] The Attorney General is given explicit authority to seek remedies of wrongdoing by not-for-profit entities, including actions directly against officers and directors that might have engaged in unlawful conduct. The authority includes the right to seek the removal of directors who authorize or acquiesce in payments or practices that are deemed inappropriate.[8] In 1997, the Board of Regents removed 18 of 19 trustees of Adelphi University for neglect of their fiduciary duties relating to an excessive compensation package for their former President and, in 1998, an action brought by the Attorney General against the former trustees for breach of fiduciary duty was upheld.[9]

Since the mid-1990s, the Internal Revenue Service has enforced clear guidelines on executive compensation that must be observed by tax-exempt not-for-profit entities. As a result, excessive compensation paid to board members and the executive leadership of the organization, as well as to anyone else who has substantial influence over the affairs of the corporation, is subject to disclosure and to IRS scrutiny. Very substantial tax penalties are levied on executives that receive excessive compensation—known as an "excess benefit transaction"—and, in appropriate cases, additional substantial liabilities are imposed directly upon members of the board of a not-for-profit entity that approved the compensation package.[10]

In reviewing whether the compensation is reasonable, the IRS reviews what compensation is received for similar services by similar organizations (whether for- or not-for-profit) and under similar circumstances.[11] Entities must demonstrate that the board actually undertook a process to establish the reasonableness of compensation. The IRS will presume the reasonableness of a compensation process if the governing board actually reviews, makes and documents the salary compensation determination, without a conflict of interest, and after obtaining and considering appropriate data and comparability information to make a reasonable fair market determination of an appropriate level of compensation.[12]

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[7] N-PCL §202(a)(12).
[8] EPTL §8-1.4(m) and (n) and N-PCL §112(a)(4), 706(d) and 714(c).
[9] *Committee to Save Adelphi v. Diamandopolous*, Regents of the University of the State of New York, February 10, 1997; *Vacco v. Diamandopoulous*, 185 Misc. 2d 724 (Sup.Ct. N.Y.Co., 1998).
[10] IRC §4958.
[11] Treas. Reg. §53.4958-4(b)(1)(ii)(A).
[12] Treas. Reg. § 53.4958-6(a).

In addition, a host of reimbursement and payment rules, adopted by virtually all relevant state agencies, are directed at ensuring that state funding is used primarily to support direct care services and to limit administrative costs. For example, certified home health agencies have, for many years, been subject to a cap on administrative expenses, while other Medicaid-funded providers have had to distinguish between allowable (and reimbursed) and non-reimbursable costs.[13] By statute, the State's Neighborhood-based Initiative program imposes a maximum percentage on administrative costs,[14] and nursing homes, Medicaid-funded clinics and substance abuse programs have also been subject by the Legislature to administrative cost caps[15]—just to name a few. Payments for administrative expenses incurred by Medicaid-funded managed care and coordinated care organizations are limited by contract. Nothing precludes state agencies from tailoring administrative expense limitations to the specific circumstances of their service systems—nor requires an across-the-board approach to containing the costs of administrative overhead.

Despite this extensive regulation, we cannot deny that there have been isolated instances in which excessive compensation has been paid. Nothing we submit here should be construed as either denying that abuses have occurred within the not-for-profit sector or condoning them. It should be noted, however, that no evidence has been advanced that suggests that widespread abuse has occurred in executive compensation or administrative expense in the not-for-profit sector in New York, among either agencies that heavily rely on state support or among those that do not. Although a Task Force on Not-for-Profit Entities was convened last summer that required not-for-profit organizations to submit very substantial information relating to their compensation practices, no analysis of the collected data has yet been released. Nor has the case been made that would support subjecting every entity that receives state support to "one size fits all" limitations on compensation and administrative expense, which do not take into account the unique nature, complexity, size or location of the contracting party or the implications on the recruitment of qualified executive leadership in the not-for-profit sector.

The Article VII legislative proposal and the Executive Order:

In the 2012-13 Executive Budget, legislation was proposed that would authorize a broad array of state agencies to limit the extent to which state funds may be used to support administrative, rather than direct care or services, and to preclude state reimbursement for executive compensation in excess of $199,000 per year. Immediately after the legislation was submitted, Governor Cuomo issued an Executive Order that directs state agencies to implement the same limitations. In both instances, if a contracting entity fails to satisfy the executive compensation and administrative spending caps, the entity's contract could be terminated or not renewed and/or state funding could be terminated.

Specifically, under the Executive Budget and the Executive Order, certain designated state agencies[16] would have the authority "to promulgate regulations or to address by other

[13] PHL §3614(7).
[14] Exec. L. §548-f(4)(d).
[15] PHL §§2808, 2807(14) and MHL, §25.09
[16] The affected agencies in the legislation include, but are not limited to, the Office for People with Developmental Disabilities (OPWDD), the Office of Mental Health (OMH), the Office of Alcoholism and Substance Abuse

means the extent and nature of a provider's administrative costs and executive compensation which shall be eligible to be reimbursed with state financial assistance or state-authorized payments for operating expenses," as detailed below:

- *Cap on "Administration" Expenses:* At least seventy-five percent of the "state financial assistance or state-authorized payments" for operating expenses of contracting entities must be "directed to provide direct care or services rather than to support the costs of administration"—terms that the applicable state agencies would be authorized to define. The mandated "direct services" percentage would increase by five percent per year until, no later than April 1, 2015, it reaches eighty-five percent, where it would remain thereafter.

- *Cap on Executive Compensation:* The legislation would also provide, "to the extent practicable," that state reimbursement would not be provided for "compensation paid or given to any executive by such provider in an amount greater than $199,000 per annum." The task of defining "compensation" and "executive" would be left to the applicable state agency. The $199,000 cap on state-supported compensation could be adjusted annually by state agencies, subject to the approval of DOB, but may not exceed "Level I of the federal government's Rates of Basic Pay for the Executive Schedule promulgated by the United States Office of Personnel Management," which is currently at essentially the same level.[17] In addition, a contracting entity may seek a waiver from compliance with this requirement from the state agency and DOB. Absent such a waiver, non-compliance with this provision may, in the sole discretion of the commissioner of the applicable agency, result in the termination or non-renewal of the state contract or the termination of state support of the contracting entity.

The Executive Order and the legislation would apply the compensation and the administrative cap to "providers of services that receive reimbursements *directly or indirectly*" from the listed state agencies.

The proposed legislation and the Executive Order are neither effective nor fair approaches to the issue and will jeopardize the ability of not-for-profit organizations to meet their missions.

Taking a "one-size fits all" approach to addressing the compensation and administrative spending practices of tens of thousands of not-for-profit organizations will not effectively curb excessive compensation by the handful of offending entities and will do harm to an already fragile New York State not-for-profit infrastructure. Rather than focusing scarce enforcement

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Services (OASAS), the Office of Children and Family Services (OCFS), the Office of Temporary and Disability Assistance (OTDA), the Department of Health (DOH), the State Office for the Aging (SOFA), the Division of Criminal Justice Services (DCJS), the Office of Victim Services (OVS) and the State Education Department (SED) The Executive Order applies to the same agencies, except the State Education Department, presumably due to its independent status.

[17] The referenced current salary schedule for such a position is $199,700 and has been frozen since 2010.

and regulatory resources on the entities that may be the actual wrongdoers, the proposal will, at a minimum, impose significant compliance costs on the vast majority of responsible contractors and will place the not-for-profit sector at a distinct competitive disadvantage as it competes for executive talent.

The proposal fails to recognize the vast disparities and variations among contracting entities and the services they render. The many thousands of not-for-profit entities that contract with State government are a hugely diverse lot, ranging from small not-for-profit entities with total revenues less than the $199,000 executive compensation cap to entities that administer over one billion dollars in revenue and oversee vast and complex service delivery systems. The notion that a single salary level should be set for each of these diverse entities—including for-profit companies that contract with state agencies—is simply unsupportable. Likewise, imposing a single administrative services percentage on a vast array of entirely disparate organizations ignores real differences in how services are rendered across the wide array of state programs that would be subject to the limitation and varying circumstances that might warrant higher or lower expenses in this category.

The proposal ignores the specialized expertise and experience that may be required by contracting entities. Many of the services rendered by contracting not-for-profit entities require uniquely qualified executive leadership to oversee the delivery of highly specialized and complex services. Take, for example, the necessity for medical leadership in certain not-for-profit entities: a large New York City based HIV services organization that requires a medical director to oversee its complex service delivery system will simply not be able to recruit a qualified physician to perform those tasks at the prescribed compensation level. Likewise, services related to care for the elderly, disabled or abused children may require executive leadership with the requisite background, professional licensure or certification, which may not be possible to find at salaries below the cap.

The proposal will render not-for-profit entities unable to compete for the best executive leadership. Leadership matters. An artificial cap on executive compensation will substantially impair the ability of not-for-profit entities to recruit and retrain highly capable, experienced and specialized executive leadership—and the quality and cost-effectiveness of the services provided by these entities will suffer as a result. Although the IRS standards focus on the comparability and the reasonableness of the compensation, viewed in the context of the human resources marketplace for executives leading similar organizations, the proposed legislation and Executive Order do not consider what it will actually take to recruit qualified leadership to these organizations. The failure to take into account the considerable geographic differences in the cost of living throughout New York State is just one critical missing element that makes the proposal unrealistic and unworkable.

The proposal will disproportionately impact on the delivery of services to the most disadvantaged New Yorkers. Both the cap on executive compensation and the limit on administrative expenses only apply to expenses financed with "state financial assistance or state-authorized payments." While the proposal is not entirely clear on this point, for- and not-for-profit contracting entities that receive a substantial amount of their revenue from non-state sources may be able to supplement compensation over the established levels and exceed the

administrative expense limitation, as long as they can demonstrate that these excesses are supported by non-state dollars.[18] Conversely, a contractor that is entirely or virtually dependent upon State support would be fully subject to the caps. Even if that entity's revenues are derived from multiple state sources, the caps on executive compensation and on administrative expenses would be applied to those state revenues in the aggregate. "Safety-net" organizations that devote themselves entirely to serving the most vulnerable New Yorkers are most likely to be those most dependent on State support and would, accordingly, be disproportionately affected by these limitations. These organizations would be unable to compete for the executive leadership against those entities that are effectively exempt from these requirements because of their non-state sources of revenue. Any proposal that disproportionately impacts upon services to the most disadvantaged New Yorkers should be seriously and critically examined.

The proposal is inconsistent with state policies that already seek to contain administrative costs. As noted above, many state agencies already condition—by statute, regulation or contract—the extent to which state funds can reimburse administrative or overhead expenses. The proposed limitations on administrative expenses in the Executive Budget and the Executive Order may be inconsistent with or otherwise complicate these already existing limitations on non-direct service expenditures. The diversity of programs and services makes it impossible and unwise to establish one correct ratio of administrative to direct care expense. Instead of enacting an inflexible, statewide approach to restraining administrative costs, it makes substantially more sense to permit state agencies to address these issues on a program by program basis with percentages or fixed dollar amounts that are tailored to the particular program and service—particularly since most state agencies have already done so.

The proposal is contrary to state policies that have urged consolidations and affiliations among state-supported contracting entities. Governor Cuomo has urged both public and private entities to examine whether consolidation or affiliation among and between entities that provide services to the public may result in the more cost-effective delivery of public services. State agencies, school districts, local governments and health care and human services providers have been encouraged to merge, consolidate or affiliate to become more efficient. While the State would presumably permit four contracting entities, funded by state revenues, to compensate their executives at $199,000 each, the merger of those four entities into a single, presumably more efficient, provider of service would subject the combined entity to the same compensation limitation. It would be highly unlikely that a qualified executive could be hired who would be willing to lead the much larger and more complex organization for the same salary of the smaller merging entities.

At the same time, the Medicaid Redesign Team (MRT) has emphasized the need to transition the Medicaid program from the current fee-for-service payment system, which reimburses tens of thousands of providers, to an emphasis on coordinated care, which will involve direct state payment to a much smaller number of managed care plans and other care coordination entities. These entities would then be held accountable for administering hundreds of millions of dollars of Medicaid revenues that pay for care rendered to their enrollees, making

[18] Even these entities would, however, incur additional compliance costs to be able to properly demonstrate that their internal allocation of resources satisfied the provisions of the legislation and the Executive Order, presumably further adding to their administrative costs.

them essentially comparable to some of the large publicly-traded health insurers in the size and scope of their operations. Making these largely state-funded entities subject to an executive compensation cap that completely ignores the actual market for executives in the health care management and insurance marketplace would deprive these entities of the specialized and experienced leadership that these entities require and would seriously undermine the policy direction sought to be advanced by the State of New York.

The proposal is potentially subject to inconsistent application. A host of terms used in the legislation and Executive Order are undefined and will require regulatory clarification by the various agencies charged with implementing these new mandates. What, for example, is included within "direct care or services" versus "administrative costs"? Will investments in information technology and other quality improvement expenditures be viewed as "administrative" costs that would be discouraged by the proposal? Which "executives" will be subject to the compensation limitation? What is included in the "compensation" cap of $199,000: is that just salary or salary and other benefits, including health, disability and retirement benefits? What State funding is encompassed by "State financial assistance or State-authorized payments for operating expenses"? And what is meant by including "providers of services that receive reimbursements directly or indirectly" from state agencies? Would this provision subject any and every sub-contractor of the contracting party since they "indirectly" receive state funds?

The legislation and the Executive Order contemplate that each of the state agencies will promulgate their own regulations to implement these requirements. It is not entirely clear what may be worse: On the one hand, if nine state agencies issue nine different interpretations of these key terms and adopt nine different approaches to the implementation of these mandates, contracting agencies would be particularly challenged if they receive state financial support from more than one state agency. On the other hand, a single set of definitions might be developed by these state agencies that ignores the substantially different services provided by an entity that is funded by, say, the Office for the Aging, as opposed to one supported by the Division of Criminal Justice Services. In short, virtually any approach to the micro-managing of the not-for-profit sector by state agencies runs the risk of doing more harm than good.

An alternative approach:

We believe there are steps that might be taken to enhance existing requirements relating to state contracting with not-for-profit entities that address these issues in a far more targeted and effective way. Rather than rely on State-issued governmental guidelines that dictate salary and administrative expense levels for thousands of organizations, we recommend that the Legislature instead strengthen existing laws and rules that will continue to hold the contracting organizations themselves accountable for the discharge of their obligations in setting reasonable compensation and administrative costs. In lieu of the Governor's legislative and Executive Order proposals, we would urge you to substitute proposals that would strengthen enforcement of the already existing regulatory requirements, such as the following:

- *Amend the Not-for-Profit Corporation Law to require not-for-profit boards to apply the Internal Revenue Code's reasonable compensation standards for tax-*

exempt organizations. To make absolutely clear that not-for-profit entities in New York are held accountable for compensation determinations they make, legislation should be adopted to mandate compliance with the existing tax-exempt organization requirements. The legislation may specifically require the adoption of compensation policies and procedures that will satisfy compliance with these requirements, including, where appropriate, policies that would require the boards to compile and review sufficient information to support the reasonableness of executive compensation.

- *Authorize the Attorney General to enforce these requirements and to require the corporation to produce evidence of its compliance with these standards, upon request.* The Legislature could authorize the Attorney General to investigate and review compliance by not-for-profit entities with the compensation requirements described above. The legislation could direct contracting state agencies to refer matters involving potentially excessive compensation to the Attorney General's Charities Bureau for further review or the Attorney General might undertake that review, as appropriate, as part of his approval of all state contracts, where excessive compensation may have been alleged. Where a contracting entity is unable to provide adequate justification for the executive compensation it provides and refuses to comply with the existing IRS standards that govern compensation, the Attorney General and/or the state agency should be given enforcement authority to take appropriate action to terminate the state contract and to hold the board of the organization accountable for the excessive compensation. Rather than having these compensation standards enforced in haphazard and inconsistent ways by the various affected state agencies, the office charged with the oversight of not-for-profit organizations in New York would provide a more consistent review of these practices.

- *Provide sufficient resources to the Attorney General's Charities Bureau to enforce these requirements:* It has been suggested that the Attorney General's Charities Bureau may not have sufficient legal or investigative resources to fulfill either its existing responsibilities or an expanded mission. While we would defer to the Attorney General's office as to the level of resources that might be necessary, we would support consideration of dedicating appropriate fee increases or other resources to ensure that the Bureau has the resources that it needs to meet its public protection responsibilities.

- *Require State agencies to adopt reimbursement and contracting practices that ensure that administrative expenses remain within appropriate levels, taking into account the specific services being rendered and other factors that may dictate the appropriate level of "overhead."* As also noted above, many state agencies already have adopted reimbursement and contracting policies aimed at limiting the extent to which state funds are utilized for administrative expenses. The Legislature could require all state agencies to promulgate regulations or to adopt contracting policies that would ensure that services are being rendered as efficiently as possible. Rather than imposing a statewide and program-wide

administrative cost mandate, state agencies should be required to tailor their reimbursement and contracting policies to minimize administrative expenses, without being saddled with an across the board and potentially arbitrary administrative cost limitation that may be either too generous or too limiting for any particular program or service.

We appreciate your consideration of these alternative approaches and would be prepared, along with our colleagues in the not-for-profit sector, to work with you in the development of sound policies to address these issues that recognize the importance of the not-for-profit sector and the complexity and diversity of the services and programs that they deliver.

Respectfully submitted,

Association For Community Living
Black Agency Executives
Catholic Charities of the Archdiocese of New York
Catholic Charities Neighborhood Services, Diocese of Brooklyn and Queens
Coalition of Behavioral Health Agencies
Family Planning Advocates of New York State
Federation of Protestant Welfare Agencies
Human Services Council of New York
Long Island Coalition of Behavioral Health Providers
Mental Health Association of New York City
Mental Health Association of Westchester
New York State Coalition for Children's Mental Health Services
New York State Council for Community Behavioral Healthcare
Supportive Housing Network of New York
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