ISSUE BRIEF 8

PAY FOR SUCCESS CONTRACTING

Contracts are the bones of Pay for Success (PFS) projects. In this brief, we outline the primary legal agreements typically used in PFS projects and discuss the key decisions that must be made to complete the contracting process.

ABOUT THIS ISSUE BRIEF SERIES

This issue brief is one of a 10-part series written **for government officials interested in learning how to use Pay for Success tools and principles.**

The series summarizes best practices and lessons learned at Social Finance from a decade of designing, launching, and managing Pay for Success projects. It includes guidance on each step of the process, from deciding whether Pay for Success is a good fit to actively managing a project post-launch.

See here to access the complete issue brief series on our website.

CONTRACTING FOR OUTCOMES INSTEAD OF SERVICES

IN TYPICAL GOVERNMENT SOCIAL SERVICES CONTRACTS, a government agency pays a service provider, on a fee-for-service basis, for each person served, regardless of the program's impact. The PFS model, on the other hand, pays for outcomes instead of services. This shift also necessitates a shift in the underlying contract structure.

In addition to introducing new types of contracts, paying for outcomes brings new partners to the table. Beyond the government outcomes funder and the service provider, PFS projects often include an independent evaluator, may include outside funders, and often involve an intermediary, acting as a hub to manage these relationships and contracts. (In the absence of an intermediary, alternative parties can take on the roles described below.) Based on Social Finance's experience in structuring PFS projects, typical legal agreements typically include:[1]

1. **PFS AGREEMENT:** The PFS agreement between the outcomes funder and the intermediary is the primary governing document of the project. It outlines the mechanism by which outcomes funds are set aside and released by the outcome funder, and articulates project details related to operations, evaluation, and governance.

   Details related to the intervention and the evaluation plan are laid out in the operations and evaluation schedules of the PFS agreement; these are then appended to the (separate) intervention and evaluation agreements (see below), making them legally binding.

2. **INTERVENTION AGREEMENT:** The intervention (or "services") agreement between the service provider and the intermediary delineates the responsibilities of the service provider in executing the intervention, including referral and enrollment targets, eligibility criteria for project participants, cohort sizes, and dates of service delivery. This agreement also includes the payment

[1] Note that, there are often additional legal entities involved to help negotiate each of these agreements.

PRIORITIZING PROJECT FIRST PRINCIPLES

In a PFS project, the process of developing legal contracts is meant to protect each of the parties involved, but ultimately these agreements need to focus on protecting and positively impacting the individuals served by the project.

During negotiations, it is imperative to prioritize the project's first principles.[2] First principles create shared project values and goals that can be used to constructively resolve disputes that may arise during the contracting process. Keeping them front and center helps align project partners around the project's true goals, and helps in navigating challenging tradeoffs.

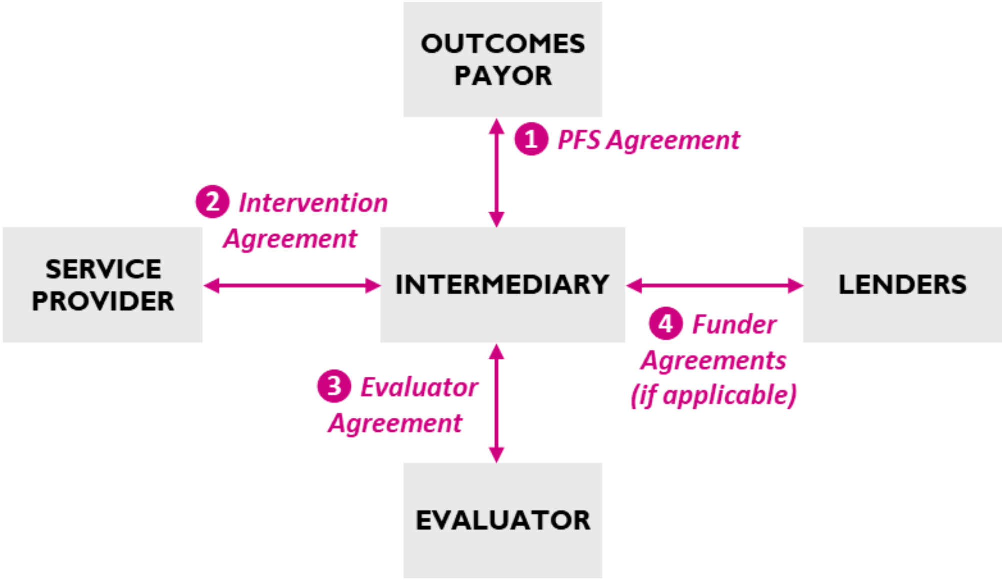
(see *Issue Brief 4 – Getting Started* for more about developing project first principles)

exhibit that sets forth the amounts and dates of payments to the service provider for performing these activities.

3. **EVALUATOR AGREEMENT:** This agreement between the evaluator and intermediary delineates the responsibilities of the evaluator in verifying whether outcomes have been achieved, including describing the evaluation methodology, the outcome metrics, and the process by which their achievement will be assessed by the evaluator, as well as processes for data sharing and management. (In some projects, the evaluator may also conduct a larger evaluation of impact beyond the payment-linked outcomes as part of a broader learning agenda.)

4. **FUNDER AGREEMENTS:** Where applicable, funder agreements between the intermediary and the funders set forth the financing terms for the contract. These agreements can differ depending on the project's financial structure.

FIGURE: TYPICAL LEGAL AGREEMENTS IN A PFS PROJECT



CONTRACTING AUTHORITY AND MECHANISMS TO SECURE OUTCOMES PAYMENTS

Before beginning the contracting process, outcomes funders must answer key questions relating to ***contracting authority*** and the ***legal mechanism to secure funding for outcomes payments***.

CONTRACTING AUTHORITY

To enter into a PFS contract, outcomes funders must be legally able to make payments directly for outcomes, rather than services, over a multi-year period. They

NAVIGATING THE NEGOTIATIONS AND APPROVAL PROCESS

Given how different PFS contracts can be from standard government contracts, defining each element of the agreement can be challenging.

To avoid surprises late in the contracting process, be sure to understand each of the partners' contract approval processes. Who are the lawyers that will be involved in drafting the agreement? Who else needs to be brought in? What is the timeline for contract approval?

should validate with their legal counsel that they have the authority to do both of these things. While some states have passed enabling legislation that facilitates entering into PFS contracts, this sort of legislation is not usually required.[2]

LEGAL MECHANISM TO SECURE OUTCOMES PAYMENTS

In most states, appropriation laws typically make funds available for one to two years; however, PFS projects typically span multiple years, with payments likely coming due throughout that time. Especially when external funding is involved, it is crucial that an outcomes funder mitigate "appropriations risk"—the risk that its legislature will not appropriate funding for future payment of obligations under a PFS contract. As described below, projects have successfully overcome this challenge in a number of creative ways; more on specific types of PFS funding mechanisms can be found in Appendix A: *Legal Mechanisms to Secure Outcomes Funding*.

UNDERSTANDING THE PFS AGREEMENT

In our projects, Social Finance uses the PFS agreement as the primary governing document for a PFS project. We divide the PFS agreement into two main sections: the ***body of the contract*** and the ***supporting schedules***.

BODY OF THE PFS CONTRACT

The body SSof the contract details key contract principles—such as the project purpose, terms, termination rights, and responsibilities of all involved parties. Some of the main provisions include:

- **PURPOSE OF CONTRACT:** Defines the social impact desired and the target population meant to benefit from the intervention.
- **TERM OF THE CONTRACT:** Outlines the date of project commencement, the date of project completion, and the requisite approvals needed for the contract to become effective.
- **OBLIGATIONS AND RESPONSIBILITIES OF THE PARTIES:** Lays out the duties of the intermediary and outcomes payor for the project. The responsibilities of the intermediary (post project-design) usually include entering into and managing ancillary agreements, such as those with the service provider and evaluator; managing project performance ("active performance management"[3]); and raising capital (when required by a project).[4] The responsibilities of the outcomes funder usually include appropriating funds for outcome payments, providing data for evaluation, and, where applicable, providing referrals to the program.

[2] "Inroads to Innovation: State Adoption of Pay for Success Legislation," Curran, Amy. https://www.chapman.com/insights-publications-Pay_for_Success_Financing_Social_Impact_Bonds.html.
[3] See *Issue Brief 9 – Active Performance Management* for more about ongoing monitoring and course-correction to ensure project success.
[4] This can also include a special purpose entity created by the intermediary for the project.

- **TERMINATION OF CONTRACT:** Specifies the circumstances or actions which may lead to the termination of the contract and the effect of an early termination on the project (i.e., continuation of services, early outcome payments, and wind down of ancillary agreements). Breaches by any of the parties to the contract can trigger termination. For example, termination may be triggered if the payor fails to appropriate funds, adequately provide necessary data, support referrals, or make outcome payments when due. Termination may also be triggered if the intermediary experiences severe underenrollment, or, where outside funders are involved, fails to secure initial funding commitments or encounters a capital shortfall. Negotiation and finalization of contract termination provisions is often one of the most time-intensive stages of project development.

SUPPORTING SCHEDULES

Project-specific details are laid out in supporting schedules to the PFS agreement:

- **OPERATIONS:** Describes the services to be delivered as part of the project, including description of the intervention model, locations of services, referral and enrollment processes, eligibility criteria for enrollment, data collection responsibilities, and timeline.
- **EVALUATION:** Outlines the independent evaluator’s plan for assessing the achievement of outcome metrics used as the basis for payments. This schedule also includes detailed definitions for each outcome metric, including the data sources to be used for measurement.
- **OUTCOME PAYMENTS:** Details the methodology of calculating outcome payments based on agreed-upon outcome metrics and price per outcome, and outlines timing and process for payment.
- **GOVERNANCE:** Establishes oversight committees and outlines roles and voting procedures of project partners in each committee.[5]
- **PUBLICITY:** Outlines publicity protocols for the initial launch of the PFS project and subsequent project milestones and activities.

[5] See *Issue Brief 10 – Pay for Success Governance* for additional information on ongoing project governance.

APPENDIX A: LEGAL MECHANISMS TO SECURE OUTCOMES FUNDING

The legal mechanisms outlined below allow payors to follow their local rules and budget mandates while still allowing them to participate in long-term PFS projects.

Mechanisms to Secure Outcomes Funding		
Funding Mechanism	**Overview**	**Example**
Full Faith and Credit	The equivalent to a General Obligation Bond, language is included in enabling legislation that PFS outcome payment obligations have the full faith and credit of the jurisdiction. Requires appropriate legislative and may require voter approval.	A Massachusetts legislative act created the Social Innovation Financing Trust Fund[6] to back PFS contracts with the "Full Faith and Credit" of the Commonwealth, up to $50M in PFS payments. To date, Massachusetts is the only jurisdiction to have done this.
Escrow Account held by Third Party	An escrow is established and held by a third party to manage government deposits should outcomes be achieved in accordance with the PFS agreement. How funds are handled if outcomes are not achieved is dependent on the specific PFS contract, but generally, any funds held in escrow at the end of the contract are returned to the jurisdiction.	In two PFS projects in South Carolina[7] and Connecticut,[8] the states make deposits into an escrow account in either an annual amount based on the next year's maximum outcome payment obligation, or in a single deposit equal to the maximum outcome payment.
Non-Lapsing PFS Fund	An account, also called a "sinking fund," created for the purpose of PFS outcome payments. Funds are deposited at project onset or periodically to meet future obligations. Unspent funds, if any, do not revert to the General Fund until the project terminates.	The New York Department of Veteran Services and the City of Boston created non-lapsing funds, protecting funds set aside for the Veterans CARE project from reverting to the General Fund at the end of the year.[9]
Annual or Biannual Line Item Appropriations	Outcome payment funds are appropriated through annual or biannual budgets. Projects must be structured to terminate in the event that sufficient funds are not appropriated.	New York State annually appropriates maximum PFS contract obligations to a line item. Unspent funds are reverted at the end of each fiscal year and must be re-appropriated in the next budget cycle.

[6] Social Innovation Financing Trust Fund, H.R. 4219, 189th Gen. Ct., Reg. Sess. (Mass. 2012), Mass. Gen. Laws ch. 10, § 35VV (2012).
[7] "Nurse Family Partnership," Social Finance. https://socialfinance.org/focus-areas/health/south-carolina-nurse-family-partnership/.
[8] "Connecticut Family Stability PFS Project," Social Finance. https://socialfinance.org/focus-areas/children-and-families/connecticut-family-stability-pay-for-success-project/.
[9] "Veterans CARE Project," Social Finance. https://socialfinance.org/focus-areas/workforce/veterans-care-project/.

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ABOUT SOCIAL FINANCE

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