



Inroads to Innovation:
State Adoption of Pay for Success Legislation

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Introduction

Pay for Success. The term “Pay for Success” (or “PFS”) refers to an innovative model for financing and implementing social services through a collaboration of public, private, and nonprofit sectors. Sometimes known as “Social Impact Bonds,” PFS financings revolve around performance-based agreements in which a government entity contracts with an intermediary organization to deliver social services in exchange for payment upon achievement of outcomes. The intermediary partners with one or more local social service providers to deliver services designed to achieve the desired outcome. Private investors or foundations provide the funding through which these social programs are enacted. A core element of the PFS financing model is that the risk of financing social services (that may not produce results) is transferred to the private sector from the local and state government entities that usually either directly fund these social services, or pay other costs that result as a consequence of the root social issue. Similar to private-sector markets, investors’ risk is rewarded or penalized proportionally to the degree of success attained. The government only repays investors if, and to the extent, targeted social outcomes are achieved. These outcome-based payments are interchangeably referred to as outcome payments, performance payments, or (as is used in this white paper) success payments. Each PFS project is structured around at least one well-defined social outcome in an intervention area.

PFS has expanded rapidly in the past five years and, while there are relatively few launched PFS programs and even fewer programs that have reached an outcome evaluation period, there are dozens if not hundreds of potential PFS projects in preliminary stages across the nation. Demand for this financing mechanism has steadily increased as information and early results have become available. While the nature of this type of financing has been alluring to specific governments and service providers up to this point, it is possible that its momentum will continue to increase as budget cutbacks create more need for alternative funding. While individual states struggle to implement balanced budgets, federal programs especially are likely to feel significant impact over the next several years. President Donald Trump introduced his inaugural budget proposal, “America First — A Budget Blueprint to Make America Great Again,” to Congress on March 16, 2017. The proposed federal budget makes drastic cuts (in some cases completely eliminating funding) to many domestic programs and federal agencies, many of which run programming or funnel federal dollars to local service providers. These service providers, as well as state and local governments, may need to look to external, private sources of funding in order to continue and grow operations in the coming years, and PFS may offer the solution.

Legislation. On January 13, 2017, the U.S. House of Representatives introduced H.R. 576, the Social Impact Partnerships to Pay for Results Act (“SIPPR”), a bill that would provide \$100 million toward PFS programs.¹ Though SIPPR has not yet been adopted into law, there has been significant legislative activity regarding PFS on the state level. At least 20 states plus the District of Columbia have introduced legislation relating to PFS and, of those, eight states have adopted such legislation, opening

¹ Social Impact Partnerships to Pay for Results Act, H.R. 576 (2017). In June 2016, the U.S. House of Representatives approved H.R. 5170, a bill substantially similar to SIPPR that was sent to the U.S. Senate for approval and was not voted on before the legislature adjourned. This legislation would give state and local governments the opportunity to apply for funding to support evidence-based programs through outcome-driven “social impact partnerships” like PFS. If passed into law, SIPPR would create two supporting bodies: the Federal Interagency Council on Social Impact Partnerships and the Commission on Social Impact Partnerships. The council, composed of appointees from several federal agencies, would be responsible for reviewing applications and determining which projects receive federal funding. The commission would conduct research for the council and provide any other assistance needed to select the strongest projects and build up PFS at the federal level.

the doors for the implementation of PFS projects in those states.² Though each of these states enacted laws related to PFS, the breadth and performance of PFS projects and legislation within each state vary substantially.

This white paper will address the legislation that has been adopted at the state level, pointing out the various functions of the PFS financing structure and how individual states have treated these components within their legislation. It is important to note that there is no such thing as a “typical” PFS transaction, and closed transactions to date have varied widely in structure, contracting parties, and funding mechanisms. While there is no standard PFS transaction, we refer to the “typical” PFS contract throughout this white paper to indicate the model on which these transactions were based. Given the varying scope of the legislation adopted thus far and the inconsistent approaches taken by individual state legislatures, a form of model state legislation included as an appendix to this white paper is designed to provide the most flexibility and broadest possible implementation of PFS within any particular state.

Terms to Understand

1. The term “**appropriations risk**” refers to the fact that, in most states, the governing body must affirmatively approve any government spending by setting aside (or appropriating) such money under an appropriations bill. Appropriations laws usually make funds available for only a one- or two-year period; however, the term of a PFS contract will typically span several years before any results are known and success payments may be due. Further, one legislature typically cannot bind a future legislature to spend money later. Therefore, there is a risk (to investors) that even though a contract has been signed by a government entity, the legislative body of that entity will not appropriate funding for the payment of obligations due under that contract in the year in which success payments would be due.

2. The doctrine of “**sovereign immunity**” grants immunity to a state from civil suit or criminal prosecution unless the state specifically waives the protection. For example, in an instance where a future legislative body fails to appropriate funds owed to investors under a PFS contract, the investor is prevented from suing the state to make payments unless the state has affirmatively waived its right to sovereign immunity with regard to that contract.

3. Within each state there are various levels of local governing bodies, often including cities, counties, and municipalities. Some states constitutionally or legislatively grant “**home rule**” to particular local governing entities. Home-rule entities have a large degree of control over their local affairs, including the authority to adopt laws and ordinances, the power to tax, and the authority to incur debt. In many ways, once a unit of local government gains home rule status, it is autonomous from state government. Home-rule entities, then, have broad power to enter into PFS contracts without explicit state authority.

In the states that do not allow home rule or that only grant home-rule authority to certain municipalities, local governing bodies are subject to “Dillon’s Rule.” Under Dillon’s Rule, a municipal

² See NONPROFIT FINANCE FUND, *Pay for Success U.S. Activity Map*, <http://www.payforsuccess.org/activity/> (last visited March 29, 2017).

corporation possesses and can exercise only the following powers: (1) those granted expressly in the words of the statute; (2) those necessarily or fairly implied in or incident to the powers expressly granted; and (3) those powers that are neither expressly granted nor fairly implied from the express grants of power but are otherwise implied as essential to the declared objects and purposes of the corporation.³ Any fair, reasonable, substantial doubt concerning the existence of a power is resolved by the courts against the corporation and the power is denied.⁴ Therefore, nonhome-rule entities are not likely to have the power to enter into PFS contracts or to make success payments under such contracts unless such power is explicitly permitted by state statute.

4. In a PFS transaction, the contract is not typically set up directly between the government and the service provider but is funneled through an “intermediary” organization. The intermediary acts as a project coordinator and manager and is often involved far before the PFS project is formalized in contract. The intermediary can, in fact, be a force in driving the initiation of a PFS transaction and is often heavily involved in the initial analysis leading to project choice, the design and structure of the project and the negotiation of the final agreements. Additionally, intermediaries recruit investors, hire service providers, and oversee the implementation of the services. Generally speaking, the intermediary is the PFS specialist in the transaction and an independent entity, separate from the government and the service provider. As an independent party, the intermediary is theoretically able to implement the contract in an unbiased way. In the past five years, a number of organizations have emerged that were founded or are now operating with the general purpose of acting as intermediaries in PFS transactions. In addition to “professional” intermediary providers, other entities that act as intermediaries include local charitable organizations and certain governmental agencies.

The intermediary will typically be a party to all contracts in the PFS transaction. In the prototypical model for a PFS financing, the government’s contract with the intermediary does not prescribe a specific service to be provided and instead grants the intermediary significant discretion to choose what services to offer to meet the agreed-upon targeted outcome. Intermediaries in this model are given the ability to choose a blend of providers and services, making mid-course corrections or overhauls if deemed necessary. Thus far in U.S. transactions, however, intermediaries have been given significantly more predefined roles, often with substantially less (or zero) discretion to change the nature of the service as the program progresses.

General Categories of Legislation

Legislation to date, adopted and unadopted, has primarily fallen into three categories: (1) Priming, (2) Enabling, and (3) Securing.⁵

“The Feasibility Study” (Priming). This form of legislative resolution does not create a specific PFS contract, provide funding, or guarantee right to payment. Instead, it authorizes a feasibility study or creates a commission to “study” the possible applications of such a funding mechanism in the state.

3 2 Eugene McQuillin, *THE LAW OF MUNICIPAL CORPORATIONS* § 4:11 (3d ed. 2006).

4 *Hawthorne v. Village of Olympia Fields*, 765 N.E.2d 475 (Ill. App. Ct. 2002).

5 See Steven H. Goldberg, *SIB Legislation in the U.S.*, *THE SOCIAL IMPACT BOND TRIBUNE*, November 2012, at 8.

(Examples: Hawaii 119 S.D. 1, Washington H.B. 2337, Vermont H.625, Nebraska L.R. 279, Rhode Island S. 2196, New Hampshire S. 69.)

“The Contract Is Allowed” (Enabling). In order to authorize the unusual funding mechanism of a PFS contract, a state may want to have its governing body expressly enable certain officials, agencies, and/or departments to enter into this new type of contract. Uncertainty about contract enforceability could lead to several issues, primarily difficulty attracting investors. (Examples: Massachusetts H.R. 4219, Colorado H.B. 15-137, Texas H.B. 3014, Idaho H.B. 170, Arkansas S.B. 472.)

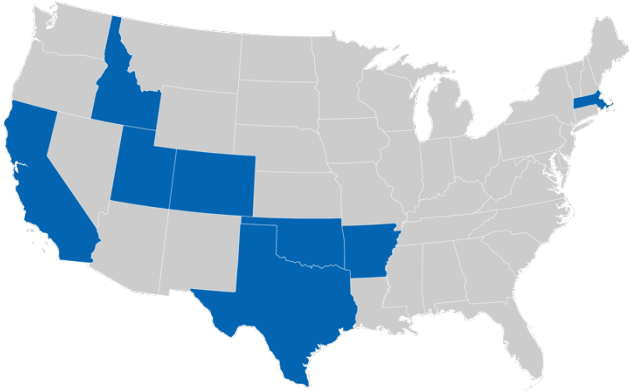
“Investor Security” (Securing). This type of legislation allows a government to back its contract with some sort of financial security such as the “full faith and credit” of the state. Otherwise, even if under contract, investors are not automatically entitled to success payments when all contractual obligations have been satisfied if the legislature does not vote to appropriate such money in the state’s budget. Though rarely introduced, many actually implemented PFS programs are backed by Securing legislation. (Examples: Massachusetts H.R. 4219, Cuyahoga County Res. No. R2014-0234, Chicago Ord. 02014-8677.)

Below, we only discuss legislation that is Enabling or Securing. There are no adopted examples of Priming legislation, but as the purpose of Priming legislation is to explore or lay the groundwork for future Enabling and Securing legislation, examples of Priming legislation are sparse on details or functionality of PFS contracts and would not be a useful addition to this white paper. While implementing a PFS program does not necessarily require PFS legislation, a PFS program is more likely to be successful and attract investors if it is clear that there is government support for the program and that investments are backed by a government entity with proper authority granted by law.

State Examples of PFS Implementation

In this section we will identify the necessary or common components of PFS legislation and explain how particular states have approached each component in successfully adopted PFS legislation. This white paper addresses (i) who may and must act as parties to a PFS contract and the various approaches different states take in defining those parties in legislation, (ii) the services authorized by the legislation to tackle specific problems and achieve targeted outcomes, (iii) the mandatory contract terms that the state legislation prescribes for each PFS contract, (iv) the financing structures of the various states to fund PFS programs and the measures states have taken to secure investments and ensure investors are repaid if a program is successful, and (v) unique clauses in various states’ PFS legislation and how those provisions differ from the typical PFS legislation.

First, provided below is a summary of the states that have adopted some form of statewide PFS legislation. We will analyze the legislation adopted in each of the states below to explain the common components of PFS legislation. Note that the State of Utah has adopted two separate pieces of PFS legislation, each enacting specific PFS programs. These two laws have substantially different provisions and will be referred to separately throughout this white paper.



The following PFS legislation has been adopted to date:

Arkansas: Pay for Success Act, Ark. Code Ann. § 12-27-204 (2015).

California: Social Innovation Financing Program, Cal. Gov't Code § 97008-97015 (2015).

Colorado: Pay for Success Contracts, Colo. Rev. Stat. Ann. § 24-37-403 (2015).

Idaho: Pay for Success Contracts — Education, Idaho Code Ann. § 33-125B (2015).⁶

Massachusetts: Social Innovation Financing Trust Fund, Mass. Gen. Laws ch. 10, § 35VV (2012).

Oklahoma: Pay for Success Revolving Fund — Criminal Justice, Ok. Stat. Ann. tit. 57 § 510.8c (2014).

Texas: Pay for Success Contracts, Tex. Gov't Code § 403.110 (2015).

Utah (Education): School Readiness Initiative Act, Utah Code Ann. § 53A-1b-101 *et seq.* (2014).

Utah (Employment): Employability to Careers Program, Utah Code Ann. §63J-4-701 *et seq.* (2017).⁷

CONTRACTING PARTIES

Any PFS program requires a contract (or group of contracts) stating the terms of the program. Many states have adopted legislation authorizing PFS contracts that specify who may act as parties to the contract. A typical PFS contract involves five parties: (1) an investor; (2) an intermediary; (3) a service provider; (4) the government; and (5) an independent evaluator.⁸ The investors fund projects up front and receive returns based on the program's success. The intermediary holds the contract with the government and helps manage the project. The service providers administer the program. The government contracts to achieve a certain outcome and pays for the success of that program. Finally, the independent evaluator determines whether the specified outcomes were met.

States adopting legislation enabling PFS programs have taken varied approaches to the level of specificity with which they describe the contracting parties involved. Idaho, for example, defines each of the contracting parties and allows the government body to fill those roles.⁹ Other states, such as Utah in its School Readiness Initiative Act (Education), which was one of the first PFS proposals to complete the full legislative process, lay out the purpose and goals of the programs but do not specify the exact parties to the contract.¹⁰

6 This Act was amended by Idaho H.B. 199, signed into law on March 24, 2017 and effective as of July 1, 2017. This white paper discusses the Idaho legislation as amended.

7 The Employability to Careers Program was passed by the Utah legislature and signed into law by the Governor of Utah on March 9, 2017. The law is effective as of May 8, 2017.

8 Corporation for National and Community Service, Office of Research and Evaluation, *State of the Pay for Success Field: Opportunities, Trends, and Recommendations* 1 (2015), <https://www.nationalservice.gov/sites/default/files/documents/CNCS%20PFS%20State%20of%20the%20Field%20Document%20Final%204-17-15%20sxf.pdf> (hereafter, "Corporation for National and Community Service").

9 IDAHO CODE ANN. § 33-125B (2015).

10 UTAH CODE ANN. § 53A-1b-110 (2014).

Investors

Investors are necessary to fund any PFS program and are thus crucial to the success of any PFS program. There are two categories of potential investors: (1) “Impact First” investors willing to accept below-market financial returns and likely drawn from a philanthropic background and (2) “Finance First” investors likely drawn from the private sector who recognize an emerging market for traditional capital gains.¹¹

In most cases thus far, funding has been provided by foundations or private investors often backed with a guarantee from a philanthropic source. There are a small number of traditional investors who have been active in the PFS market already, most notably Goldman Sachs Group, Inc. (through designated funds like the Social Impact Fund and the Urban Investment Group). In one instance, Bank of America Merrill Lynch acted as a placement agent, recruiting and tracking smaller investments.¹²

All PFS programs include investors, but states vary as to whether they specifically mention investors in their legislation. Many states allow PFS programs to be funded by private entities but do not place specific limits on who those investors may be or how much they may or must contribute. Idaho defines an investor as “an individual or entity that provides the capital for the services specified in a contract.”¹³ California requires that funds from investors and government grants will be used to finance the PFS program and “administrative expenses” related to the program, with any “remainder of the grant ... contributed toward final payments to investors for successful” program outcomes.¹⁴

Some states, such as Massachusetts, Utah, Texas, and Arkansas, do not refer to “investors” specifically or regulate who may invest in a project. Rather, the legislation dictates the terms of the government appropriations pledged to the specific project. For example, Massachusetts requires that the “secretary shall be the trustee of the trust ... and shall ensure that all funds appropriated ... [are] deposited in the trust” but does not reference the individual or institutional investors’ roles in funding the projects.¹⁵ Texas also requires that an individual, the “comptroller,” control the government funds appropriated toward the projects but does not specify who may invest in the projects.¹⁶ Arkansas references a possible agreement (“may include without limitation”) with one or more “private entities” regarding a loan to fund the program’s delivery or a guarantee for loans obtained under the contract.¹⁷ Utah (Education) does not define “investor,” but the legislation implies private entities act as investors, stating, “The board may provide for a repayment to a private entity to include a return of investment.”¹⁸

11 See BRIDGES VENTURES, *ET. AL.*, INVESTING FOR IMPACT: CASE STUDIES ACROSS ASSET CLASSES 6 (2010).

12 This occurred in New York, where “Social Finance and Bank of America Merrill Lynch recruited over 40 individual and institutional investors to contribute \$13.5 million in equity for the project” to fund a PFS project aimed at reducing recidivism rates. Corporation for National and Community Service, Office of Research and Evaluation at 1, 12-13 (2015).

13 IDAHO CODE ANN. § 33-125B(10)(d) (2015).

14 CAL. GOV’T CODE § 97011 (2015).

15 MASS. GEN. LAWS CH. 10, § 35VV (2012).

16 TEX. GOV’T CODE § 403.110 (2015).

17 ARK. CODE ANN. § 12-27-204 (2015).

18 UTAH CODE ANN. § 53A-1b-110 (2014).

Similarly, the Utah (Employment) statute, while not explicitly defining “investor” requires that any eligible program must have the “ability to attract private or philanthropic investors.”¹⁹

Alternatively, a state not only can sharply regulate the *source* of funds but can limit the actions of such party through its legislation. For example, a state may decide to limit an investor’s role to that of a passive capital contributor by eliminating the investor’s ability to directly participate in the PFS project. Colorado takes this approach and requires that investors help fund the PFS project, but “an investor that is funding the activities of a lead contractor ... is prohibited from dictating the manner of delivery of services to be provided.” However, this “does not prohibit an investor from performing due diligence on its investment or managing the investment.”²⁰

Intermediaries

In a typical PFS transaction, intermediaries coordinate PFS projects by choosing a service provider, receiving funds from investors, facilitating contract negotiations, overseeing the project, and ensuring an independent evaluator measures the success of a program. However, state legislation does not typically specify who may act as an intermediary for the program or even that the program must have an intermediary. Instead, states authorize government boards or individuals to contract with outside parties as necessary to implement PFS programs. For example, Massachusetts, the first state to implement PFS legislation, does not reference the role of intermediaries in its legislation.²¹ Nevertheless, Massachusetts Juvenile Justice PFS Initiative, a program implemented pursuant to this legislation, uses Third Sector Capital Partners, a nonprofit organization that helps develop and implement local PFS projects, as the intermediary.²² Similarly, Utah’s Education legislation does not require an intermediary.²³ However, United Way of Salt Lake acts as the intermediary that is responsible for the overall implementation for the Utah Pre-K Project, pursuant to the School Readiness Initiative Act.²⁴

On the other hand, Utah’s (Employment) legislation specifically addresses the role of intermediary and categorizes such position into two parties: (i) a “fiscal intermediary” (see “Other Clauses of Interest — Fiscal Intermediary” below) and (ii) a “programmatic intermediary.” Pursuant to the Utah (Employment) legislation, a programmatic intermediary must be experienced in results-based financings and evidence-based policy such that it can validate a feasibility analysis, structure the PFS contract and raise the “private investment capital” necessary to fund the program.²⁵

Service Providers

The intermediary organization is typically responsible for selecting a service provider who acts as a contractor overseeing the PFS project. In contrast to intermediaries, which are often absent from PFS-enabling state legislation, most states specifically allow for (or require) a service provider or multiple

19 UTAH CODE ANN. § 63J-4-705(3)(f) (2017).

20 COLO. REV. STAT. ANN. § 24-37-403 (2015).

21 MASS. GEN. LAWS ch. 10, § 35VV (2012).

22 Corporation for National and Community Service, at 15.

23 UTAH CODE ANN. § 53A-1b-110 (2014).

24 Corporation for National and Community Service, at 10.

25 UTAH CODE ANN. §§ 63J-4-701(7) and (10) (2017).

service providers. For example, Idaho requires that each PFS contract specify a service provider and defines that party as “an organization that implements an evidence-based program that conforms to the terms of the contract.”²⁶

Several states assume the existence of service providers in PFS contracts by referencing these organizations in the legislation but do not specifically define the term “service provider.” For example, Massachusetts and California, using identical language, each require that any PFS contract include “a calculation ... of payments that would be earned by the service provider during each year of the agreement if performance targets are achieved”²⁷ (note that the service provider may “earn” the success payments but these payments are, in most instances, paid to the investors who funded the program or, in some instances, shared by the investors and the service providers). Similarly, Oklahoma requires the government to pay the social service providers, with certain spending limits placed on those providers; thus, their presence in the contract is implied.²⁸ Although this legislation does not define the term “service provider,” the PFS projects implemented pursuant to these acts do utilize service providers to oversee the projects. Massachusetts, for instance, uses Roca, Inc., a company serving high-risk youth, as the service provider.²⁹

Other states refer to service providers abstractly without using the term “service providers” by allowing the government to negotiate with private entities or contractors that presumably function as service providers. For example, Utah’s Education legislation refers to such organizations as “private entities,”³⁰ Colorado allows for “lead contractors” who may hire other contractors,³¹ and Arkansas refers to these organizations as “community-based providers” with expertise in the specific goals of the PFS program.³² Texas provides perhaps the most flexibility for selecting intermediaries and service providers by allowing the government to contract with “any person” subject to limits based on costs and the program’s success.³³

In contrast, the Utah (Employment) legislation defines “Eligible program provider” and lists many criteria that must be considered by the government and the intermediary before such provider can be selected, including not just the entity’s capacity to effectively implement the program but the entity’s ability to provide necessary data for analysis, and its ability to attract investors. However, it is worth noting that according to its definition, an “eligible program provider” can mean one organization or a group of organizations.³⁴

26 IDAHO CODE ANN. § 33-125B(10)(e) (2015).

27 MASS. GEN. LAWS ch. 10, § 35VV (2012); Cal. Gov’t Code § 97011 (2015).

28 OKLA. STAT. ANN. tit. 57 § 510.8c (2014) (“The Office of Management and Enterprise Services shall provide payment to social service providers ... [but] shall approve only those contracts that meet the ... requirements”).

29 Corporation for National and Community Service, at 1, 15.

30 UTAH CODE ANN. § 53A-1b-101 *et seq.* (2014) (“[T]he School Readiness Board ... may enter into contracts with private entities to provide funding for early childhood education programs for at-risk students”).

31 COLO. REV. STAT. ANN. § 24-37-403 (2015) (“[A] contract must ... [s]pecify [the] program-eligible interventions provided by the lead contractor”).

32 ARK. CODE ANN. § 12-27-204 (2015) (“The Department of Community Correction may enter into an agreement with entities, including ... community-based providers specializing in behavioral health, case management, and job placement services, [etc.]”).

33 TEX. GOV’T CODE § 403.110 (2015) (“[A] state agency and the comptroller jointly may enter into a success contract with any person”).

34 UTAH CODE ANN. §§ 63J-4-701(4), 63J-4-705(3) (2017).

Government

When it comes to the government entity, all adopted legislation obviously requires or assumes the role of the government, but states do vary as to “where” government authority is located. Many states authorizing PFS transactions specify an office or individual with authority to enter into contracts subject to cost and purpose limitations. Massachusetts gives the Secretary of Administration and Finance authority to enter into PFS programs, and the Secretary ensures funds are available for the program by requesting appropriations based on the services delivered in that year.³⁵ Like Massachusetts, Texas gives authority to an official (the comptroller) to act as a trustee with power to execute contracts with the state agency, service providers, and intermediaries.³⁶

In contrast, some states give a specific board or department the authority to enter into contracts complying with the program’s stated purpose and limitations based on the stated goals of the PFS contracts in that state. Utah, for example, gives authority to each of the School Readiness Board (Education) and the Employability to Careers Program Board (Employment), each within the Governor’s Office of Management and Budget, to enter into and negotiate PFS contracts focused, respectively, on early childhood education and employability/workforce training.³⁷ In Arkansas, the Department of Community Correction has the power to enter into contracts with private entities to create a PFS program, as all PFS contracts in Arkansas must be focused within the inmate community and/or must reduce recidivism.³⁸

Other states rely on the state budget office to create and negotiate PFS contracts. For example, in Oklahoma the Office of Management and Enterprise Services, a state agency that assists with creation of the state budget, must be the contracting party in a PFS contract.³⁹ Similarly, the Colorado Office of State Planning and Budget contracts with the local government and service providers to implement PFS programs in Colorado.⁴⁰

Independent Evaluators

Most state legislation authorizing PFS programs specifies that an independent evaluator will measure the success of the program. Because an investor’s return depends on the success of a PFS program, independent evaluators are crucial to measure whether a program has achieved its benchmarks, and the methodology used by the independent evaluator is often articulated in the contract terms. See “Mandatory Contract Terms — Defined Metrics and Objectivity” below for more information. Typically, firms or social science labs unaffiliated with the government, the service provider, or the intermediary act as evaluators to develop objective, scientific methods to ultimately determine whether the program has successfully reached its benchmarks. Massachusetts requires “an objective process”

35 MASS. GEN. LAWS ch. 10, § 35VV (2012) (“[T]he secretary of administration and finance ... may enter into pay for success contracts[,] and the secretary shall request an appropriation for each fiscal year that the contract is in effect”).

36 TEX. GOV’T CODE § 403.110 (2015) (“The trust fund is established to provide a fund from which the comptroller as trustee may make success contract payments due in accordance with the contract terms without the necessity of an appropriation for the contract payment”).

37 UTAH CODE ANN. §§ 53A-1b-101 *et seq.*; 63J-4-701 *et seq.*

38 ARK. CODE ANN. § 12-27-204 (2015).

39 OKLA. STAT. ANN. tit. 57 § 510.8c (2014).

40 COLO. REV. STAT. Ann. § 24-37-403 (2015).

where an “independent evaluator will determine whether the [defined] performance targets have been achieved,”⁴¹ and Colorado follows suit using identical language.⁴² Likewise, Utah (Education) includes “a requirement for an independent evaluator to determine whether the performance outcomes have been achieved,”⁴³ and California’s legislation specifies that the county is required to select an independent evaluator who “will determine whether the performance targets have been achieved” through “an objective process” with “defined performance metrics and a monitoring plan.”⁴⁴ Arkansas also requires an “independent third party” to measure the success of the program and “determine whether the performance targets have been achieved.”⁴⁵

Other states do not require an independent evaluator but rather rely on the service provider or government entity to evaluate the program’s success. For example, Oklahoma requires the social service provider to “provide verifiable evidence of successful completion rates of persons who participated in the diversion or reentry program offered by the service provider.”⁴⁶ Texas relies on “[e]ach state agency” to provide a report with “details about the success in achieving the specified performance measures of each success contract.”⁴⁷ Legislation allowing governmental bodies or service providers to serve in the evaluator role may create problems for potential investors because these agencies and service providers have an incentive (or disincentive) to show the programs have been successful, making an objective evaluation difficult or impossible.

AUTHORIZED SERVICES

In a traditional PFS structure, a transaction is designed to address a specific social issue facing a particular population. For example, projects initiated to date include attempts to (1) reduce recidivism through released inmate programming, (2) mitigate special needs education costs by funding early childhood education programs, (3) reduce out-of-home foster placement for children of parents with substance abuse issues and homeless mothers, (4) improve water quality through green infrastructure, (5) reduce hospitalizations of mentally ill adults, (6) improve early-childhood development for children of low-income mothers, (7) increase suitable employment in adults without high school diploma equivalent, and (8) reduce emergency services for homeless populations through rehabilitation and treatment.

Though individual PFS contracts will operate best when designed to tackle very specific problems, for state legislative purposes there is no need to narrow the scope of the potential projects to be initiated. However, to date, several states have adopted legislation that limits the implementation of the PFS structure to targeted outcomes, services, or populations. In other cases, states have adopted legislation that can be broadly applied across state social services to implement a range of PFS contracts. Notwithstanding political or capital considerations, taking the general approach is preferred to allow for maximum flexibility and application.

41 MASS. GEN. LAWS ch. 10, § 35VV (2012).

42 COLO. REV. STAT. Ann. § 24-37-403 (2015).

43 UTAH CODE ANN. § 53A-1b-101 *et seq.* (2014).

44 CAL. GOV’T CODE § 97011 (2015).

45 ARK. CODE ANN. § 12-27-204 (2015).

46 OKLA. STAT. ANN. tit. 57 § 510.8c (2014).

47 TEX. GOV’T CODE § 403.110 (2015).

Targeted Legislation

Targeted legislation will primarily address one or more of three defined target areas: *(1) targeted populations, (2) targeted services, and (3) targeted outcomes*. In any one statute, any one or two, or all three, could be addressed. For examples of how each of these target areas can be implemented, we can look to three separate states that have generally enacted legislation aimed at reducing recidivism.

Often, in cases where the state has implemented some form of targeted legislation, the authority to enter into and maintain PFS contracts is vested in a particular department or agency of the state related to the targeted service or population. However, it is not necessarily the case that targeted PFS contracts cannot be held under general state agencies. Oklahoma, for example, enacted substantially limited legislation that houses PFS programs under the state Office of Management and Enterprise Services, the state's central finance and operations agency. Under this statute, PFS contracts are limited to "criminal justice programs that have outcomes associated with reducing public sector costs."⁴⁸ The statute further narrows the possible scope of contracts by defining criminal justice programs as "diversion or reentry" programs that can only be provided to individuals who are not currently inmates within the Oklahoma Department of Corrections. Presumably, this limits possible PFS contracts to serve (1) at-risk individuals who have never entered the Oklahoma corrections system or (2) former inmates who have been released. Thus, Oklahoma has enacted a *targeted population, targeted outcomes* form of legislation because any programming must be aimed at diversion from correctional institutions or reducing reentry into correctional institutions and can only serve individuals not currently imprisoned.

In California, the enacting statute is also limited to PFS programs that work to reduce recidivism.⁴⁹ However, in contrast with the Oklahoma statute, the California statute does not identify any particular individuals who will be targeted for programming and instead identifies (without limiting) broader social service areas such as homelessness, substance use disorder, and unemployment, which are known to impact recidivism. Therefore, California has taken a *targeted outcomes* approach and has implemented legislation that allows for a broad range of services to an undefined set of individuals, all with the primary goal of achieving one particular measurable outcome.

Finally, Arkansas has implemented legislation in which the Department of Community Correction pays for intervention services "only if certain performance targets are met, including *without limitation* a reduction in the reincarceration rate in Arkansas correctional facilities."⁵⁰ Thus, Arkansas has enacted a *targeted population* form of legislation. The language in the statute limits PFS contracts to programs for "incarcerated individuals or individuals on parole or probation," though, significantly, the programs are not limited to reducing recidivism and, conceivably, could be introduced to produce some other result within the specific population articulated. Particularly, later in the statute, the language is explicit that payment is "based on reduced rates of reincarceration *or other agreed-upon measures of success*."⁵¹ Therefore, in Arkansas, the enacted legislation is focused on providing services to a particular cohort of constituents without mandating the type of service or the resulting outcome.

48 OKLA. STAT. ANN. tit. 57 § 510.8c (2014).

49 CAL. GOV'T CODE § 97011 (2015).

50 ARK. CODE ANN. § 12-27-203 (2015) (emphasis added).

51 *Id.* at (c)(3)(C) (emphasis added).

General Legislation

General legislation, unlike targeted legislation, has broader application. It does not require any of the defined target areas outlined above and instead makes a blanket allowance for a particular type of contract/financing, either broadly or through a specific state department or agency. In most cases, the legislation does define a general expected outcome such as “to improve outcomes and lower costs ...”⁵² or “to improve the lives and living conditions of individuals ...”⁵³ These broad outcome expectations provide almost unlimited flexibility to enact PFS contracts.

MANDATORY CONTRACT TERMS

While most state legislation prescribes required terms for a PFS contract, states vary in the degree of specificity with which they lay out the required contract terms. For example, the Colorado legislation contains eight required terms, including provisions describing the roles of the parties, the duration of the contract, events upon execution and termination of the contract, and the procedures parties to the contract must follow.⁵⁴ In contrast, the Arkansas legislation contains only two required terms, including that the contract is conditioned upon meeting defined metrics and that an independent third party must evaluate the program.⁵⁵ The level of specificity in the legislation affects the state’s flexibility to implement a PFS program. This section will discuss the most common mandatory contract terms that state legislation requires.

Defined Metrics and Objectivity

Although state legislation often mentions an independent evaluator and an objective process, some states go so far as to require that the PFS contracts contain provisions outlining the objective procedure. Massachusetts, California, Colorado, and Texas all require the PFS contract to lay out an objective process or procedure for assessing the success of the program, but the states differ in whether and how they define an “objective” process. California provides the most comprehensive explanation, defining an “objective process” as one where “an independent evaluator, selected by the county, will determine whether the performance targets have been achieved [according to] defined performance metrics and a monitoring plan.”⁵⁶ Massachusetts,⁵⁷ Colorado,⁵⁸ and Texas⁵⁹ define an “objective process” as one “by which an independent evaluator” determines whether the project has met the specified targets.

52 “There shall be established and set up on the books of the commonwealth a trust to be known as the Social Innovation Financing Trust Fund for the purpose of funding contracts to improve outcomes and lower costs for contracted government services, hereinafter referred to as ‘pay for success contracts’, subject to the requirements of subsection (b).” MASS. GEN. LAWS ANN. ch. 10, § 35VV(a).

53 “Program-eligible interventions’ means services provided in order to improve the lives and living conditions of individuals by increasing economic opportunity and the likelihood of healthy futures and promoting child and youth development.” COLO. REV. STAT. ANN. § 24-37-402(6).

54 COLO. REV. STAT. ANN. § 24-37-403 (2015).

55 ARK. CODE ANN. § 12-27-204 (2015).

56 CAL. GOV’T CODE § 97011 (2015).

57 MASS. GEN. LAWS ch. 10, § 35VV (2012).

58 COLO. REV. STAT. ANN. § 24-37-402(3) (2015).

59 TEX. GOV’T CODE § 403.110 (2015).

Some states do not specifically define an objective process but do stress the need for clear, measurable standards to be provided for by the PFS contract. In Oklahoma, for example, a PFS contract must require the service provider to “provide verifiable evidence of successful completion rates of persons who participated” in the program.⁶⁰ Similarly, Idaho and Arkansas require an evaluator to determine whether the program has met specific benchmarks.⁶¹

Realization of Savings

In addition to requiring an objective process, Massachusetts, California, and Idaho also require that the program, if successful, result in overall savings to the state. Massachusetts and California require all PFS contracts to contain “a determination ... that the contract will result in significant performance improvements ... and budgetary savings ... if the performance targets are achieved.”⁶² Idaho simply requires that the contract identify the “source of moneys from which savings will be realized.”⁶³

Not all states authorizing PFS contracts require that the program, if successful, result in budgetary savings. Oklahoma, for example, does not mention savings, and in fact the only budgetary constraint in its legislation is a minimum contribution by a service provider who “can provide not less than Two Million Dollars (\$2,000,000) in capital to fund the delivery of services necessary to achieve the predefined ... outcomes.”⁶⁴ Colorado, which otherwise has very detailed and comprehensive legislation, makes no mention of budgetary savings requirements.⁶⁵

Other Mandatory Contract Terms

Although the most common mandatory contract terms are conditioning payment on the program’s success, objectively defining clear metrics, and ensuring budgetary savings, these are not the only contract terms required by state legislation. For example, in Colorado, each PFS contract must “[c]learly define the type, scope, and duration of the program-eligible interventions that the lead contractor will directly or indirectly provide,” define the procedures of the program and the roles of each party to the contract, and “[i]nclude a clause that specifies any causes for and the procedures for early termination of a contract.”⁶⁶ Colorado’s legislation provides less flexibility for structuring PFS programs and contracts than states with fewer required terms, but these more rigid requirements may help to ensure that Colorado PFS programs have clearly defined benchmarks and procedures and could promote standardization and, thus, replicability in Colorado PFS programs. This rigid structure, as well as standardization across programs, may additionally help attract investors.

Utah (Education) also contains unique required terms, mandating privacy surrounding student data. Each PFS contract must have a required term “that the private entity is not eligible to receive or

60 OKLA. STAT. ANN. tit. 57 § 510.8c (2014).

61 IDAHO CODE ANN. § 33-125B(5) (2015) (“The external evaluator shall ... [d]etermine whether the service provider has met the agreed upon efficacy standards under the terms of the contract.”); ARK. CODE ANN. § 12-27-204 (2015) (“An agreement ... [s]hall include ... an independent third party to evaluate the pay-for-success program to determine whether the performance targets have been achieved.”).

62 MASS. GEN. LAWS ch. 10, § 35VV (2012); Cal. Gov’t Code § 97011(4) (2015).

63 IDAHO CODE ANN. § 33-125B(1)(c) (2015).

64 OKLA. STAT. ANN. tit. 57 § 510.8c (2014).

65 COLO. REV. STAT. ANN. § 24-37-402(3) (2015).

66 COLO. REV. STAT. ANN. § 24-37-403(3)(a) and (h) (2015).

view any personally identifiable student data of students funded through a results-based contract.”⁶⁷ On the other hand, Utah (Employment) requires that each participant in an a PFS program has “given written permission and signed and acknowledgement that the participant’s data may be shared....”⁶⁸ Thus, Utah legislation requires that the PFS contract include terms besides those that are directly tied to the program’s success or budgetary issues, based on concerns that may arise because of the specific intervention contemplated by the Utah legislature.

SUCCESS PAYMENTS

A core element to the PFS financing model is that the risk of financing social services (that may or may not produce “success”) is transferred to the private sector from the local and state government entities that usually fund these services. Similar to private-sector markets, investors’ risk is rewarded or penalized proportionally to the degree of success attained. The government only repays investors if, and to the extent, targeted social outcomes are achieved.

Among adopted legislation, there is a spectrum of mechanisms used to define the structure and definition of success payments. In most cases, the legislation is deliberately vague on the specifics of the success payments except that they are a key component of any contract. One of the primary differentiations among the legislation is whether or not the entirety of any success payment must be outcome-dependent. Under the “typical” PFS formula, a success payment is totally outcome-dependent and an investor would receive zero repayment if defined success metrics were not achieved by the date set for evaluation.⁶⁹

However, some states have adopted legislation that allows some deviation from this formula if agreed to by the contracting parties. For example, in Massachusetts only a “substantial portion” of the state’s payments must be conditioned on the achievement of performance targets.⁷⁰ This language allows the option for the state to share in the financial risk with investors. Similarly, in Texas only a “majority” of the success payments must be predicated on the outcomes of the contract.⁷¹ A “majority” is a clearer guideline than a “substantial portion” because it gives significant room for other payment conditions but makes clear that the performance outcomes must be the most significant consideration for any payments to investors.

The above instances are the only two adopted thus far to directly authorize shared government risk in success payments; however, no currently adopted legislation explicitly prohibits contract terms from permitting success payments determined based on factors beyond project outcomes. It is likely that states that authorize shared risk will have greater appeal to potential investors who could be assured of some regular payment notwithstanding performance targets.

⁶⁷ UTAH CODE ANN. § 53A-1b-110 et seq. (2014).

⁶⁸ UTAH CODE ANN. § 63J-4-704(5)(a) (2017).

⁶⁹ *See, e.g.*, ARK. CODE ANN. § 12-27-204 (2015) (“An agreement ... shall include [a] requirement that payment be conditioned on the achievement of specific outcomes based on defined performance targets.”).

⁷⁰ MASS. GEN. LAWS ch. 10, § 35VV (2012) (“Each contract shall include ... a requirement that a substantial portion of the payment be conditioned on the achievement of specific outcomes based on defined performance targets.”).

⁷¹ TEX. GOV’T CODE § 403.110 (2015) (“[A] success contract ... must include ... that a majority of the contract payment is conditioned on the contractor meeting or exceeding certain specified performance measures toward the outcome of the contract’s objectives.”).

In Arkansas, a PFS agreement “[m]ay contain a graduated payment schedule to allow for varying payments based on different levels of performance targets....”⁷² This tracks with the traditional PFS formulation; however, Arkansas is the only state to explicitly mention graduated payments.

Finally, several states, including California and Massachusetts, include language related to success payments such as a requirement that the payment be conditioned on the achievement of “specific outcomes based upon defined performance targets.”⁷³ However, the meanings of the terms “specific outcomes” and “defined performance targets” are within the discretion of the contracting parties, allowing significant flexibility and granting broad power to the government party.

FUNDING AND SECURITY

PFS programs are designed to apply the mechanics of traditional capital markets; thus, while philanthropic in their focus, investors aim to receive a return on their initial investment. As a result, PFS offers the potential to promote a “double bottom line,” *i.e.*, provide effective solutions for social problems and financially reward risk-bearing investors for their support of successful social services. A PFS financing structure almost always requires the approval of the local government authority, which specifies the source of funding to ensure that the programs are funded and that the funds are secured so that investors will be assured repayment if targets are met.

Sources of Funding

A financing structure that permits an investment in a successful PFS program to be repaid requires the approval of the local government authority, so states that have enacted PFS legislation have addressed the funding of these programs in their legislation. Typically, PFS legislation will provide that the state legislature will appropriate funds for repaying investments in successful PFS programs.⁷⁴

The legislation may demand that the money be appropriated into a specific fund designated for the PFS program. For example, Massachusetts requires that, if the Secretary chooses to enter into a PFS contract, the contract “shall include” a sinking fund requirement, where the Secretary has a contractual obligation to request an annual appropriation in an amount determined based on the prescribed formula. Were the legislature to reject the request for an appropriation, no funds would be available for payment.⁷⁵

Similarly, the California legislature must appropriate funds for deposit in the Recidivism Reduction Fund. The Board of State and Community Corrections grants those funds to the three selected counties to be used for success payments and to pay administrative expenses of the PFS program (only

72 ARK. CODE ANN. § 12-27-204 (2015).

73 CAL. GOV'T CODE § 97011 (2015) (“Each county contract ... shall include ... [a] requirement that the payment be conditioned on the achievement of specific outcomes based upon defined performance targets.”); MASS. GEN. LAWS ch. 10, § 35VV (2012).

74 *See, e.g.*, COLO. REV. STAT. ANN. § 24-37-403(6) (2015) (“The pay for success contracts fund is hereby created in the state treasury. The principal of the fund consists of ... [m]oneys appropriated or transferred to the fund by the general assembly that have become available or are expected to become available due to direct or indirect reductions in state spending.”); TEX. GOV'T CODE § 403.110 (2015) (“The comptroller and a state agency may not finally execute a proposed success contract under this section unless ... the legislature has appropriated for deposit to the credit of the trust fund ... an amount of money necessary.”).

75 “Each contract shall include: ... (4) a sinking fund requirement under which the [Secretary of Administration and Finance] shall request an appropriation for each fiscal year that the contract is in effect, in an amount equal to the expected payments that the commonwealth would ultimately be obligated to pay in the future based upon service provided during that fiscal year, if performance targets were achieved....” MASS. GEN. LAWS ch. 10, § 35VV (2012).

10% of the grant funds may be used to pay administrative expenses; the rest must be used for success payments).⁷⁶ California also imposes a requirement whereby the grant funds provided by the state must be matched, at a minimum, dollar for dollar by other county, federal, private, or philanthropic funds. The Board of State and Community Corrections is not permitted to make the grants to the selected counties until both the legislature has appropriated funds to the Recidivism Reduction Fund and the matching funds are identified.

However, some states do not require appropriations for PFS programs but rather propose funding projects through direct funding or other sources of funding. Some states have attempted to circumvent the appropriation issue by creating a direct source of funding for PFS projects in the legislation. For example, the Utah (Employment) legislation creates a general fund to be used for success payments that may consist of (i) appropriations, (ii) income and interest from investment of the moneys, and (iii) private donations.⁷⁷ By explicitly allowing private donations in the general account, this statute circumvents an absolute need for state appropriations.

Other states do not specify the source of funds but instead allow the state and the PFS program flexibility to determine the source of funds. For example, Colorado has specific statutory language allowing for money deposited into the PFS fund to be “transferred” by the legislature instead of “appropriated”; however, there is no indication where such money would be sourced other than appropriations.⁷⁸ In Idaho, it appears from the statutory language that funds for possible success payments do not have to be appropriated by the legislature for the express purpose of funding a PFS contract but may instead be drawn from the funds appropriated by the legislature generally to the “public school support program.” This may allow some flexibility with respect to legislative appropriations and grants even more authority to the state department of education when determining whether to enter a PFS contract.⁷⁹

Security Risks and Legislative Solutions

Although PFS contracts purport to guarantee that investors will receive a return on their investments if the program is successful, investors may have cause for concern given that legislation typically requires government approval for all funding appropriations and that the state cannot be sued if it fails to pay back investors. Thus, as discussed in Part II, some of the primary difficulties with the PFS framework involve the concepts of “appropriations risk” and “sovereign immunity.”

76 “Upon appropriation of funds by the Legislature for deposit in the Recidivism Reduction Fund for the purposes of this title,” the Board “shall award a grant in an amount of not less than five hundred thousand dollars (\$500,000) and not more than two million dollars (\$2,000,000)” to each selected county. “The total amount of the grants awarded ... shall not exceed five million dollars (\$5,000,000) ... [an] amount equal to a minimum of 100 percent of the Social Innovation Financing Program grant awarded to the county [must] be matched by other county, federal, private, or philanthropic, funds.” CAL. GOV’T CODE § 970011 (2015); *see also* CAL. GOV’T CODE § 97008 (2015) (defining “Board” as used in the state’s Social Innovation Financing Program).

77 UTAH CODE ANN. § 63J-4-703(2) (2017).

78 “The principal of the fund consists of: (I) Moneys appropriated or transferred to the fund by the general assembly that have become available or are expected to become available due to direct or indirect reductions in state spending resulting from the provision of program-eligible interventions programs under a contract entered into pursuant to subsection (2) of this section; and (II) Any other money that the general assembly appropriates or transfers to the fund.” COLO. REV. STAT. ANN. § 24-37-403(6).

79 Any contract shall provide “[t]he state’s payment obligations from the money appropriated to the public school support program, if the efficacy standards are met under the contract.” IDAHO CODE ANN. § 33-125B(1)(e) (2015). The Idaho legislation includes an amendment to the state Educational Support Program calculation, indicating that state support for contracts created under Section 33-125B will be subtracted from total state funds dedicated to the educational support program. IDAHO CODE ANN. § 33-1002(2)(u) (2017).

To address investors' concerns and foster buy-in from private investors, states have attempted to limit the risks to investors by requiring that contracts cannot be entered into until an appropriation is made and by waiving sovereign immunity. However, most efforts to limit risks of non-repayment are likely insufficient to give potential investors full confidence in their ability to force the state (or other governmental entity) to make payments under contract.

Texas legislation requires that the legislature appropriate funds for the purpose of paying success payments *before* any PFS contract may be executed to minimize investors' risk of not being repaid (this type of legislation is "securing" legislation, as discussed in Part III). Thus, in Texas, before a PFS contract can even be executed by the contracting parties, the legislature must have made an appropriation large enough to encompass all possible future success payments over the entire course of the contract. If made, this appropriation would likely satisfy investors whose payments would be secured in a trust fund.⁸⁰ However, it is likely there would be significant political obstacles to making such a large appropriation in any given year. Since a contract cannot be entered into at all unless such appropriation is made, this is a substantial roadblock for any prospective PFS contract. In the event that an appropriation is able to be made, it is likely to be at a smaller dollar amount, meaning that the scale of the services provided must be similarly reduced.

In another example, Massachusetts has included a rare provision whereby the Secretary of Administration and Finance is allowed, in his/her discretion, to secure the obligations of the state under a PFS contract with "the full faith and credit of the Commonwealth."⁸¹ The Massachusetts legislature would still need to make an appropriation for the success payments. However, once an appropriation is made, this provision does establish an investor's right to sue the state (for up to \$50,000,000) if earned success payments are not made (if, for example, the legislature still refused to make the appropriation). Without this provision, the state would be immune from suit due to sovereign immunity, which is the case in all other adopted PFS statutes to date.

Colorado legislation also provides security to investors by allowing flexibility for money to be transferred to fund a program. Although Colorado requires legislative appropriation and is clear that the state's obligation under the contract is subject to such appropriation, the statute does allow for appropriations to be made with (1) realized savings, (2) expected savings (without rules as to what can create an expectation), and (3) any other money the legislature may wish to transfer to the fund. This at least gives broad authority for money to be transferred to the fund, presumably even without a contract in place yet, which, if necessary, could provide the security required by a potential investor.⁸²

80 A trust fund is established "to provide a fund from which the comptroller as trustee may make success payments due in accordance with the contract terms without the necessity of an appropriation for the contract payment." However, a proposed PFS contract cannot be finally executed unless: "(2) the legislature has appropriated for deposit to the credit of the trust fund, contingent on the execution of the contract, an amount of money necessary to administer the contract and make all payments that may become due under the contract over the effective period of the contract." TEX. GOV'T CODE § 403.110 (2015).

81 "The secretary may provide that payments in future years under any such contracts shall constitute a general obligation of the commonwealth for which the full faith and credit of the commonwealth shall be pledged for the benefit of the providers of the contracted government services, but the total amount of payments under such contracts secured by a pledge of the full faith and credit of the commonwealth shall not exceed, in the aggregate, \$50,000,000." MASS. GEN. LAWS ch. 10, § 35VV (2012).

82 "... a contract must ... (g) State that any request for payment made by the lead contractor is subject to approval by the office and that the obligation of the office to make any payment is subject to annual appropriation by the general assembly ... The principal of the fund consists of: (I) Moneys appropriated or transferred to the fund by the general assembly that have become available or are expected to become available due to direct or indirect reductions in state spending resulting from the provision of program-eligible interventions programs under a contract entered into pursuant to subsection (2) of this section; and (II) Any other money that the general assembly appropriates or transfers to the fund." COLO. REV. STAT. ANN. § 24-37-403(3) (2015).

It should also be pointed out that there is risk to investors regardless of the security mechanisms put in place by the state legislature because of the nature of PFS contracts. If the success targets are not achieved, the investors will not be repaid.

OTHER CLAUSES OF INTEREST

Early Involvement of Parties to the Contract

California takes a unique approach to establishing PFS financing in the state by creating a Social Innovation Financing Program that will essentially administer a state grant program. The Social Innovation Financing Program then accepts applications from counties in the state to receive grant funding. One result of this mechanism is California’s PFS legislation requires each application for a future contract to describe “all parties to the proposed contract, including prospective investors and philanthropic foundations.”⁸³ Unlike a typical PFS program, where investors and grant-makers are not finalized or even approached until the PFS financing is structured, this statute requires the funders to be on board much earlier in the process. Under the California model, investors would need to be identified even before the state has determined if the county will receive grant funding (and thus will be able to proceed with a PFS project).

Allowing Interested Parties to Propose PFS Programs

Like most PFS programs, Idaho specifies that a government entity, here the State Department of Education, may enter into contracts for services.⁸⁴ However, Idaho differs from the traditional model because interested parties may also approach the department about the need for a service within the department and can submit proposals to negotiate a contract for a new program.⁸⁵

Ban of Federal Funds and Mandatory Public Comment

In Colorado the statute provides, “A contract shall not require or authorize the state to use federal moneys to make success payments unless federal law or federal regulations authorize the use of federal moneys for that purpose. Before it enters into a contract, the office shall make the contract available to the public on the office’s web site and provide an opportunity for public comment regarding the contract.”⁸⁶ This provision is notable because (1) there is a specific bar against using federal moneys for success payments unless specifically authorized by federal law or regulation and (2) there is a mandatory public comment requirement where the contract itself must be posted publicly online before the contract is executed and final. Practically, there is no time requirement for posting and no method offered for receiving any public comments.

83 CAL. GOV’T CODE § 97010 (2015) (“At minimum, each application for a grant shall include ... [a] description of the proposed social program [and a] description of all parties to the proposed contract, including prospective investors and philanthropic foundations.”).

84 Idaho Code Ann. § 33-125B(1) (2015) (“The state department of education may enter into contracts for approved services.”).

85 IDAHO CODE ANN. § 33-125B(1) (2015) (“[T]he department may issue a request for information for a contract upon identification of a need for a special service, or interested parties may identify a need for service within the department and submit a proposal to the department to negotiate a contract.”).

86 COLO. REV. STAT. ANN. § 24-37-403(3) (2015).

Mandatory Request for Proposal

Also in Colorado, the statute dictates how solicitations for contracts must be managed. Specifically, the act requires: “Before entering into a pay for success contract authorized by this section, the office, one or more local governments, or the office and one or more local governments shall conduct a request for proposal process. The request for proposal must describe the desired population to be served, desired outcomes, and the potential duration of a pay for success program and may include performance targets. The office shall make a request for proposal issued pursuant to this subsection ... publicly available on its web site upon its issuance.”⁸⁷ Colorado differs from most PFS legislation because it lays out a detailed process that the government entity must follow to request proposals.

Colorado also describes the process that the government entity must follow to review proposals and enter into contracts. The statute specifies: “Entry into such a contract is generally subject to the requirements of the ‘Procurement Code’, articles 101 to 112 of this title, and the office is encouraged, but not required, to use the request for proposals process specified in section 24-103-203.”⁸⁸

Fiscal Intermediary

The Utah (Employment) legislation is the first to introduce the concept of a “fiscal intermediary.”⁸⁹ Pursuant to statute, the fiscal intermediary means a “nonprofit community foundation located in the state that establishes and manages charitable funds and that has the necessary experience to coordinate the funding and management of a results-based contract and related program.”⁹⁰ The statute further defines a “results-based contract” as a contract between the government party, a service provider, and a fiscal intermediary “that will result in repayment to the fiscal intermediary.” A fiscal intermediary, then, replaces the for-profit investor under a typical PFS contract and instead acts as trustee of funds which will presumably come from, and be forwarded to, an external investor.

Other Legislation

States are not the only legislative bodies to approach or enact PFS focused legislation. In several cases, local government entities have adopted legislation in order to implement specific programs.

Cuyahoga County. Cuyahoga County, Ohio adopted “enabling” legislation on July 22, 2014 to enact a PFS project designed to reduce out-of-home foster-care placements for children of homeless parents.⁹¹ On October 28, 2014, the County adopted Resolution No. R2014-0234, authorizing a specific program to be implemented in the county, and funded the first of five annual \$1 million appropriations for deposit into the Social Impact Financing Fund to make success payments in accordance with the

⁸⁷ COLO. REV. STAT. ANN. § 24-37-403(2) (2015).

⁸⁸ COLO. REV. STAT. ANN. § 24-37-403(3) (2015).

⁸⁹ UTAH CODE ANN. § 63J-4-701(7) (2017).

⁹⁰ UTAH CODE ANN. § 63J-4-701(7) (2017).

⁹¹ Cuyahoga County, Ohio, Ordinance No. O2014-0018 (July 22, 2014).

“Partnering for Family Success” PFS contract.⁹² This “securing” resolution paved the way for the specific program while the earlier “enabling” ordinance allowed generally for PFS contracts at the county level.

City of Chicago. On October 8, 2014, the City of Chicago, a home rule unit, adopted a “securing” ordinance authorizing the city to secure the loan of funds from an intermediary organization to the Board of Education of the City of Chicago to implement a PFS early-childhood education program meant to reduce the use of special education services in Chicago-based schools.⁹³

District of Columbia. On October 2, 2014, the District of Columbia published Act 20-424, the “Fiscal Year 2015 Budget Support Act of 2014,” an “enabling” act that ultimately resulted in the first environmental PFS project. The project funded green infrastructure that aims to control stormwater runoff and improve water quality.⁹⁴

Denver. The Denver City Council passed a “securing” ordinance on January 23, 2017, implementing a PFS program in the City of Denver meant to provide treatment, rehabilitation and support services designed to keep homeless populations out of the city criminal justice population.⁹⁵

Federal Legislation. As described in the introduction to this white paper, several pieces of federal legislation relating to the PFS financing model have been passed by Congress and other legislation is currently pending; however, a summary of such legislation is outside the scope of this white paper.

Conclusion

As described throughout this white paper, state legislation enabling PFS transactions has been enacted on a limited scale and varies widely. In addition to the legislation described herein, other legislation has been proposed throughout the country that has not been enacted for various reasons. As PFS transactions continue to transition from feasibility discussions to implementation and, most importantly, reach the evaluation stage, it is our hope that more state legislatures will consider implementing legislation to enable additional transactions to be developed. In furtherance of that goal, we have prepared and included as an appendix to this white paper, model legislation ready to be tailored to meet the needs of any state considering this innovative new financing tool.

92 Cuyahoga County, Ohio, Resolution No. O2014-0234 (Oct. 28, 2014).

93 City of Chicago, Illinois, Ordinance No. 02014-8677 (Oct. 8, 2014).

94 61 D.C. Reg. 9990 § 1131 *et. seq.* (September 23, 2014).

95 City and County of Denver, Colorado, Ordinance No. 0779 (Dec. 22, 2014).

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Appendix A — Model Act

The following “model” legislation provides the components we believe are needed to fully take advantage of the PFS financing mechanism, borrowing pieces of effective legislation that has already been enacted throughout the country. This “model” legislation is both broad and flexible but, at the same time, retains the key components of the PFS financing model. However, it is important to note that this is meant to be a model and therefore would need to be tailored to the specific state and must comply with the state constitution.

XX-100. Preamble.

(1) The legislature finds that there are many prevention-based social service programs and services that demonstrably result in positive impacts for individuals and families of this State that are cost-beneficial and that efficiently utilize government resources. However, because government resources are limited, the State is often unable to fund these programs or services.

(2) The legislature also finds that new, innovative financing models, such as pay-for-success initiatives, are emerging, and these new models allow the up-front expenditure of private funding by nongovernmental entities for effective social service programs and services described above. These contracts with private entities for up-front investments allow the public to benefit from prevention-focused programs and services while shifting the risk of these innovative programs to private investors. In addition, these innovative financing models provide an opportunity for governments to transition from a model of paying service providers for a defined quantity of services to a model where investors are reimbursed by the state only upon the successful completion of agreed-upon financial and/or social outcomes stemming from the social service intervention.

(3) The legislature also finds that, in a pay-for-success financing arrangement, an investor pays for a social service that targets a specific population, with designated outcomes that must be achieved. The government entity will then pay the investor a specified amount only if the designated outcomes are met.

(4) The legislature further finds that pay-for-success financing arrangements encourage partnerships among the public, private and philanthropic sectors; emphasize accountability in the rendering of services; and encourage the use of sophisticated program evaluations.

XX-101. Short title.

This Act shall be known and may be cited as the “Pay for Success Financing Act.”

XX-102. Definitions.

As used in this part, unless the context otherwise requires:

(1) “Defined Performance Targets” means the performance targets specified in a Pay for Success Contract to be achieved by the Service Provider as a result of the Program-Eligible Interventions.

(2) “Independent Evaluator” means a person, organization or entity that is independent and separate from all other Parties, including the Investor, the Intermediary, the Local Government and the State, and is responsible for independently determining whether the Program-Eligible Interventions achieved the Specific Outcomes based on Defined Performance Targets that result in Success Payments being owed by the State or Local Government pursuant to the Pay for Success Contract.

(3) “Intermediary” means any corporation, limited liability company, limited liability partnership, partnership or other entity, which is not the State, the Local Government, the Service Provider or the Investor, that contracts with other Parties to implement a Pay for Success Project. The Intermediary’s duties may include:

(a) negotiating and structuring the Pay for Success Contract;

(b) raising sufficient capital to fund all costs related to the Pay for Success Project;

(c) deploying capital and providing guidance and management to Service Providers; and

(d) assisting with establishment of the evaluation of the Defined Performance Targets.

(4) “Investor” means a person or entity that provides the capital to fund Program-Eligible Interventions and/or costs of implementing a Pay for Success Project.

(5) “Local Government” means a city, county, municipality or other political subdivision of the State.

(6) “Party” means any party to a Pay for Success Contract.

(7) “Pay for Success Contract” means one or more loan agreements, service agreements, pay-for-success contracts, fee-for-service contracts, guaranty agreements or other contracts or agreements, or any combination thereof, between or among the State, the Local Government, the Intermediary, the Service Provider, the Investor and/or any other party (including guarantors), or any combination thereof, required to implement a Pay for Success Project authorized by the Pay for Success Contracts Program.

(8) “Pay for Success Contracts Fund” means the Pay for Success Contracts Fund created in Section ___ of this Act.

(9) “Pay for Success Contracts Program” means the Pay for Success Contracts Program established in Section ___ of this Act.

(10) “Pay for Success Project” means a project authorized under the Pay for Success Contracts Program.

(11) “Program-Eligible Interventions” means services provided to citizens within the State or Local Government to improve the lives and living conditions of individuals or families in the State or Local Government, to improve the economic opportunity of citizens of the State or Local Government or to generally improve the public health, safety, education and welfare of the citizens of the State or Local Government.

(12) “Service Provider” means one or more persons or entities, which may be Local Governments, that perform or provide Program-Eligible Interventions, either directly or through subcontractors.

(13) “Specific Outcomes” means the outcomes resulting from a Pay for Success Project if the Defined Performance Targets are achieved by the Service Provider.

(14) “State” means the State of _____, or any department, agency, board or commission thereof.

(15) “Success Payments” means payments required to be made pursuant to a Pay for Success Contract upon the achievement of Specific Outcomes based on Defined Performance Targets specified in a Pay for Success Contract.

XX-103. Pay for Success Contracts Program.

(1) There is hereby established the Pay for Success Contracts Program. The purpose of the program is to provide authorization, subject to specified requirements and limitations set forth in this Act, for the State or Local Government to enter into Pay for Success Contracts to implement Pay for Success Projects.

(2) The State or Local Government is hereby authorized to enter into Pay for Success Contracts to implement Pay for Success Projects. The State or Local Government shall not enter into a Pay for Success Contract unless it has determined that the Pay for Success Project will result in specific quantifiable public benefits and/or monetary savings for the State if the Defined Performance Targets are achieved.

(3) Neither the selection of a Party to a Pay for Success Contract or a participant in a Pay for Success Project nor entry by the State or Local Government into a Pay for Success Contract shall be subject to the requirements of the [reference State’s procurement code].

(4) No Success Payments owed by the State or Local Government pursuant to any Pay for Success Contract shall be paid unless funds therefor have been appropriated to the Pay for Success Contracts Fund established by this Act.

(5) Any Pay for Success Contract authorized by this Act shall:

(a) clearly define the type, scope and duration of the Program-Eligible Interventions, either by implementing a new services program or expanding an existing services program to serve a new or expanded population, or both, and the Specific Outcomes sought based on Defined Performance Targets;

(b) require that all or a substantial portion of the Success Payments be conditioned on the achievement of Specific Outcomes based on Defined Performance Targets;

(c) detail the roles and responsibilities of each Party to the Pay for Success Contract and any identified subcontractors;

(d) state that once the Pay for Success Contract is executed, an Investor is prohibited from dictating the manner of delivery of the Program-Eligible Interventions. This paragraph (d) does not prohibit an Investor from performing due diligence on its investment or managing the investment;

(e) provide for an objective process by which an Independent Evaluator determines whether the Defined Performance Targets have been achieved or exceeded;

(f) include a repayment schedule assuming that Defined Performance Targets are achieved as determined by the Independent Evaluator, which repayment schedule may be graduated to allow for varying payments based on different levels of achievement of Defined Performance Targets;

(g) require that the State request appropriation by the general assembly to the Pay for Success Contracts Fund created under this Act in an amount sufficient to pay any required Success Payments, assuming Specific Outcomes are achieved, for each fiscal year that the Pay for Success Contract is in effect;

(h) state that any obligation of the State or Local Government to make any Success Payment is subject to annual appropriation by the general assembly to the Pay for Success Contracts Fund created under this Act; and

(i) include a clause that specifies any causes for, and the procedures for, early termination of the Pay for Success Contract; requires at least ninety days' notice of a proposed termination to each Party to the Pay for Success Contract and any Service Provider; and requires a transition plan that minimizes any negative impact on the individuals being served by the Program-Eligible Interventions should early termination occur.

(6) Any Service Provider providing Program-Eligible Interventions must be licensed or accredited by the applicable State agency or department.

(7)(a) A fund to be known as the Pay for Success Contracts Fund is hereby created in the State Treasury for the purpose of funding Success Payments owed by the State or Local Government pursuant to Pay for Success Contracts. The principal of the Pay for Success Contracts Fund shall consist of:

(I) moneys appropriated or transferred to the Pay for Success Contracts Fund by the general assembly that have become available, or are expected to become available, due to direct or indirect reductions in State spending resulting from a Pay for Success Project; and

(II) any other money that the general assembly appropriates or transfers to the Pay for Success Contracts Fund.

(b) The State Treasurer is the trustee and administrator of the Pay for Success Contracts Fund. The Pay for Success Contracts Fund must be maintained separately from the general fund of the State and all other funds. The State Treasurer shall make Success Payments from the Pay for Success Contracts Fund only in accordance with the terms and conditions of a Pay for Success Contract authorized by the Pay for Success Contracts Program.


(c) A Pay for Success Contract may be initiated in any one fiscal year and extend into subsequent fiscal years. Appropriations from any such fiscal years may be expended to fund Success Payments owed by the State or Local Government pursuant to such Pay for Success Contract.

(d) Interest and income earned on the deposit and investment of money in the Pay for Success Contracts Fund are credited to the Pay for Success Contracts Fund. Subject to annual appropriation by the general assembly, the State shall expend moneys in the Pay for Success Contracts Fund to make Success Payments as required by Pay for Success Contracts and to pay any administrative expenses incurred in connection with Pay for Success Contracts.

(e) The State Treasury may establish within the Pay for Success Contracts Fund one or more accounts to fund Success Payments for a particular Pay for Success Project for which funds have been appropriated to the Pay for Success Contracts Fund.

(8) Funding provided by a nongovernmental entity to fund a Pay for Success Project to be implemented under the terms of a Pay for Success Contract is not a grant, as defined in Section (____), even if the funding is not ultimately required to be repaid because the entity receives contractual consideration from the State in exchange for the funding in the form of a promise to make Success Payments if the Pay for Success Project is successful.

(9) Unless otherwise specifically provided, nothing in this Section exempts the State, a Service Provider or any other person involved in the provision of Program-Eligible Interventions from the requirements of any applicable federal, state or local law or rule.



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