

CONTRACTING (INCOMPLETELY) FOR SUCCESS: DESIGNING PAY FOR SUCCESS CONTRACTS FOR SOCIAL IMPACT BONDS (SIBS)

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More than two dozen social impact bonds have been launched in the United States since the first was contracted by New York City in 2012. Dozens more of these transactions are in progress across the United States, and more are likely to come prompted, at least in part, by the Social Impact Partnerships to Pay for Results Act (SIPRA) of 2018.

As the number of social impact bonds has grown, the architecture of the pay for success contracts that undergird social impact bonds is starting to take recognizable form in the United States. What explains the design of these pay for success contracts and where are they heading next?

Nobel Laureate Oliver Hart's work in developing a theory of incomplete contracting is relevant to understanding the design of the pay for success contracts that were developed for the first social impact bonds launched in the United States from 2012 through 2017. Not only does this theory explain why many of these early transactions include contractual governance and oversight structures, but it also points to how future pay for success contracts used for social impact bonds might develop and standardize as private and public actors gain more experience with contracting for successful social or environmental outcomes.

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“It is very gratifying to see the world’s first Social Impact Bond do good and do well, helping released prisoners lead better lives and, as a result, paying back investors’ capital with a reasonable return and saving the government money. It is the way of the future.”

—Sir Ronald Cohen
Chairman, Global Steering Group on
Impact Investment (July 2017)¹

¹ Press Release, Social Finance and One Service, World’s 1st Social Impact Bond shown to cut reoffending and to make impact investors a return (July 27, 2017) [hereinafter Peterborough SIB Press Release].

INTRODUCTION

This is an article about the contractual design of the first Social Impact Bonds (called “SIBs”) launched in the United States.² More colorfully, this is an article about beds that need to be emptied, blank sheets of paper, and the prescient insights of a Nobel Laureate about how parties create long-term contracts when confronting a world full of uncertainty.

This Article focuses on the pay for success contracts that undergird the first five years of SIBs launched in the United States—from 2012 through 2017.³ It suggests that the design of these pay for success contracts, at least as being used in the United States, falls in line with a pattern of contracting that contract theorists, such as Nobel Laureate Oliver Hart, might predict of incomplete contracts of this nature. More specifically, this Article examines the extent to which many of these early pay for success contracts rely on contractual governance and oversight structures to respond to the wide range of possible eventualities that will determine whether social service interventions are effective, and, consequently, whether SIB investors will receive outcome payments. Given the relatively limited role of SIB investors in these governance and oversight structures, this Article then focuses on other means by which SIB investors aim to protect their interests when contracting for SIBs—structurally and contractually. Finally, this Article concludes with an exploration of how pay for success contracts for SIBs might evolve and even standardize going forward.

But first a little background on the state of SIBs, both globally and in the United States.

I. STATE OF SIBS: GLOBALLY AND IN THE UNITED STATES

On July 27, 2017, the results of the world’s first SIB were announced publicly, prompting the celebratory remarks of Sir Ronald Co-

² While the focus of this Article is limited to how SIB transactions are contracted in the United States, readers may find useful lessons from the U.S. experience that could be applied to other jurisdictions that are currently engaging in SIB transactions or are considering doing so in the future. Valuable further research also could draw from scholarship in the field of law and economics literature to focus on the design of the legal rules that set the stage for future pay for success and other outcomes-based contracting.

³ These include New York City (2012); Salt Lake City, Utah (2013); New York State (2013); Massachusetts—Juvenile Justice (2014); Chicago, Illinois (2014); Massachusetts—Chronic Homelessness (2014); Cuyahoga County, Ohio (2014); Santa Clara County, California (2015); South Carolina (2016); Denver, Colorado (2016); Washington, D.C. (2016); Connecticut (2016); Salt Lake County, Utah (2017—two impact bonds issued together); Massachusetts (2017); Oklahoma (2017); Alameda, California (2017); Los Angeles, California (2017); and Ventura, California (2017). SOCIAL FINANCE, <https://sibdatabase.socialfinance.org.uk/> (last visited Feb. 10, 2019) [hereinafter Social Finance Impact Bond Database] (providing a full list of the SIBs in operation and in development).

hen quoted above. This first SIB was launched in 2010 in Peterborough, United Kingdom, with the goal of reducing the high rate of reconviction events by short-sentenced offenders.⁴ More specifically, the Peterborough SIB aimed to reduce the reconviction rate of short-sentenced offenders by at least seven and one-half percent overall compared to a control group.⁵ The Peterborough SIB exceeded that target by reducing the reconviction rate by nine percent.⁶ As a result, the 17 investors in the Peterborough SIB were repaid their initial capital plus a return of just over three percent per annum for the period of their investment.⁷

While the Peterborough SIB has been heralded as a success, it experienced challenges. Early results of this first SIB did not demonstrate a sufficiently large reduction in reconviction rates to trigger early outcome payments (also called “success payments”) to its investors.⁸ Then, in 2015, the Peterborough program was terminated. This termination, which took place after the first two cohorts of offenders participated in the program, was due to a change in national policy that introduced mandatory statutory supervision for all short-sentenced offenders. As a result, it was no longer practical to continue to provide or measure the impact of social services contracted under this SIB.⁹

Since the Peterborough SIB was launched in 2010, there has been growing global interest in creating SIBs to spur and scale social innovation. As of January 2019, around 130 SIB or SIB-like (also called “pay for success”)¹⁰ transactions had been launched in more than two dozen countries, raising over \$430 million in the aggregate.¹¹ The United King-

⁴ Peterborough SIB Press Release, *supra* note 1, at 1–2.

⁵ *Id.* at 1.

⁶ *Id.* at 4.

⁷ *Id.* at 1.

⁸ The Peterborough program was initially designed to run for seven years (until 2017) working with three groups of 1,000 short-sentenced offenders. The results for the first cohort were published in August 2014 and showed a reduction of 8.4% in reconviction rates. This was short of the 10% reduction in reconviction rates necessary for an early outcome payment to be made based on the results of an individual cohort. The second cohort achieved a 9.7% reduction in reconviction rates, also short of the 10% rate necessary to trigger an early outcome payment. Together, however, the two cohorts had a weighted average of a 9% reduction in reconviction rates, which was above the minimum threshold of 7.5% necessary to trigger the final outcome payment. *Id.* at 4; *see also* JAKE ANDERS & RICHARD DORSETT, NAT’L INST. ECON. SOC. RES., HMP PETERBOROUGH SOCIAL IMPACT BOND 1 (2017).

⁹ The service provider, One Service, continued to operate on a fee-for-service basis until the Community Rehabilitation Companies began service delivery. *See* Peterborough SIB Press Release, *supra* note 1, at 4.

¹⁰ The terms “SIB” and “pay for success,” will be used interchangeably in this Article even though it can be argued that pay for success contracts may encompass a broad range of deals extending beyond SIBs. Similarly, this Article will use the terms “success payments” and “outcome payments” interchangeably.

¹¹ Social Finance Impact Bond Database, *supra* note 3. Outside of U.K. and the U.S., impact bonds have been issued in Austria, Australia, Belgium, Cameroon, Canada, Colombia, Congo, Finland, France, Germany, India, Israel, Japan, Kenya, Netherlands, New Zealand,

dom accounts for the largest number of these transactions to date (over one-third),¹² but there also has been interest in transacting SIBs in the United States, which accounts for twenty percent of these transactions.¹³

The number of U.S. SIB deals is likely to grow as dozens more are in development.¹⁴ And more are likely to come, fueled, at least in part, by the passage in 2018 of the Social Impact Partnerships to Pay for Results Act (“SIPPRA”).¹⁵ SIPPRA appropriated \$100 million in federal funds to be directed to state and local governments to support “Social Impact Partnership Demonstration Projects.”¹⁶ The federal funding to be distributed as part of SIPPRA will be disbursed in the form of grants to

Peru, Portugal, South Africa, South Korea, Sweden, Switzerland, Uganda and a multi-country impact bond launched in the DRC, Mali and Nigeria. *See id.*

¹² *Id.* (providing data that shows the United Kingdom accounts for 47 SIBs). The U.K. SIBs present marked structural and design differences from those taking place in the United States. The U.K. SIBs are generally much smaller in size than those transacted in the United States. To put this in context, for 19 of the first 32 SIB transactions in the U.K., the average initial investment was under one million pounds. Also, many of the U.K. SIBs condition payments to investors on the achievement of output goals, not outcomes. Consequently, very few of the U.K. SIBs are subject to independent impact evaluations. Some U.S. SIBs also look to output indicators, but not to the same extent as U.K. SIBs. *See* KEVIN ALBERTSON ET AL., PAYMENT BY RESULTS AND SOCIAL IMPACT BONDS: OUTCOME-BASED PAYMENT SYSTEMS IN THE UK AND US 45, 111–14 (2018).

¹³ Social Finance Impact Bond Database, *supra* note 3 (providing data that shows the jurisdiction with the next highest number of SIBs, after the United Kingdom, is the United States with 26 SIBs).

¹⁴ Tina Rosenberg, *Issuing Bonds to Invest in People*, N.Y. TIMES (Mar. 6, 2018), <https://www.nytimes.com/2018/03/06/opinion/social-projects-investing-bonds.html> (reporting that United States has 20 SIBs in which \$211 million has been invested in the aggregate, and at least 50 more SIBs are in development in the United States).

¹⁵ Social Impact Partnerships to Pay for Results Act, 42 U.S.C. § 1397n–1397n-13 (2018).

¹⁶ More specifically, the purposes of SIPPRA are to:

- “(1) To improve the lives of families and individuals in need in the United States by funding social programs that achieve real results;
- (2) To redirect funds away from programs that, based on objective data, are ineffective, and into programs that achieve demonstrable, measurable results;
- (3) To ensure Federal funds are used effectively on social services to produce positive outcomes for both service recipients and taxpayers;
- (4) To establish the use of social impact partnerships to address some of our Nation’s most pressing problems;
- (5) To facilitate the creation of public-private partnerships that bundle philanthropic or other private resources with existing public spending to scale up effective social interventions already being implemented by private organizations, nonprofits, charitable organizations, and State and local governments across the country;
- (6) To bring pay-for-performance to the social sector, allowing the United States to improve the impact and effectiveness of vital social services programs while redirecting inefficient or duplicative spending; and
- (7) To incorporate outcomes measurement and randomized controlled trials or other rigorous methodologies for assessing program impact.”

See 42 U.S.C. § 1397n.

states and local governments.¹⁷ Movement also is taking place at the state level in the United States with a growing number of states enacting legislation that expressly authorizes specified government agencies to undertake SIB or SIB-like projects.¹⁸

SIBs present an unusual alignment of public and private interests whereby the performance risk of social service contracting is transferred from the public sector to private sector investors. Related, the amount of financial return paid by government “outcome” payors to these private investors is positively correlated to the extent to which desired performance outcomes are generated by the social services contracted for as part of these transactions.¹⁹ This risk/return allocation is in marked contrast to other forms of impact investing where financial returns sometimes are traded off for social returns.²⁰

The Peterborough SIB is not the first nor the only SIB to fully repay its investors.²¹ As of January 2019, more than 30 SIBs had reached their

¹⁷ In February 2019, the U.S. Department of the Treasury (“Treasury”) issued a “Notice of Funding Availability” and invited applications for state and local governments to apply for grant awards under SIPPRA. Treasury anticipates making 5–15 grants for demonstration projects. See U.S. DEP’T OF TREASURY, SOCIAL IMPACT PARTNERSHIPS TO PAY FOR RESULTS ACT DEMONSTRATION PROJECTS (2019), <https://home.treasury.gov/system/files/226/SIPPRA-NOFA-FINAL-FY2019.pdf> [hereinafter NOFA]. Under this first NOFA, Treasury will make grants to state and local governments for up to \$66,290,000 for payments for successful outcomes of social impact partnership projects and up to \$9,940,000 to pay costs of independent project evaluations. A separate NOFA will be issued later in 2019 for feasibility study grants. *Id.* at 2–3.

¹⁸ NONPROFIT FINANCE FUND, [https://payforsuccess.org/activity/?facets\[0\]=activity_type:resource&sort=recent](https://payforsuccess.org/activity/?facets[0]=activity_type:resource&sort=recent) (last visited Feb. 27, 2019); see also *infra* note 47 (discussing the content commonly found in enabling legislation being enacted by states in the United States).

¹⁹ The SIB payments that are made to investors can come in three forms—(i) interest payments (if interest payments are to be made, these typically are not conditioned on outcome indicators being met because, in the early years at least, there are no demonstrable outcomes that could be measured), (ii) principal payments, and (iii) outcome or success payments (the amount of principal and outcome/success payments to be made to investors typically are conditioned on the extent to which specified outcome indicators were met or exceeded). See generally Dana Archer-Rosenthal, *Pay for Success: The First Generation* 28 (2016) [hereinafter *Pay for Success*], <https://payforsuccess.org/resource/nff-issues-report-first-generation-pay-success>.

²⁰ See Abhilash Mudaliar et al., *Annual Impact Investor Survey 3* (2018), https://thegiin.org/assets/2018_GIIN_Annual_Impact_Investor_Survey_webfile.pdf (stating that among surveyed impact investors in 2017, 64% targeted risk-adjusted, market-rate returns and 36% targeted below-market rate returns. Of those survey respondents willing to accept below-market rate returns, 20% of respondents targeted returns closer to market rate and 16% targeted returns closer to capital preservation).

²¹ Annie Dear et al., *Social Impact Bonds: The Early Years* 6 (2016), https://socialfinance.org/content/uploads/2016/07/SIBs-Early-Years_Social-Finance_2016_Final.pdf (stating that as of July 2016, 22 SIB transactions from around the world had reported performance data. Of these 22 SIBs, 21 indicated positive social outcomes, 12 made outcome payments (either to investors or recycled payments into service delivery), and 4 repaid investors in full).

maturity date, and most of those maturing SIBs repaid their investors in full plus a positive return.²²

Yet not all SIBs have succeeded in reaching their anticipated performance outcomes. Most notable is the first SIB launched in the United States, which is the only SIB to date where the outcome payor made *no* principal or outcome payments to its investor.²³ This SIB, contracted in 2012, aimed to reduce by at least 10 percent the historical reincarceration rate of youthful offenders (ages 16–18) at the Rikers Island Correction Facility. The outcomes payor of the Rikers SIB was the City of New York’s Department of Corrections. A single investor, Goldman Sachs Bank, agreed to provide a loan of up to \$9.6 million to the intermediary, MDRC, to fund the scaling of preventive social interventions through a program called the NYC Adolescent Behavioral Learning Experience (“ABLE”) Project for Incarcerated Youth (at Rikers Island).²⁴ Bloomberg Philanthropies guaranteed 75 percent of the Goldman loan.²⁵

Goldman disbursed its loan in tranches to MDRC, rather than provide the entire loan in one disbursement. This tranching structure allowed Goldman to mitigate the risk that ABLE’s interventions might not reduce recidivism rates. More specifically, after receiving an interim evaluation report about changes in the recidivism rates of the first cohort of youths enrolled in the ABLE program at Rikers Island, Goldman could determine whether to continue lending.²⁶

In July 2015, after the first three years of service delivery, ABLE announced that the recidivism rates of the first cohort of youths showed no appreciable difference from historical rates over the two years following the youths’ enrollment in the ABLE program. As a result, Goldman decided to stop disbursing, and instead turned to the Bloomberg guarantee to recoup its invested capital, thereby terminating the Rikers SIB.²⁷

While the results of the ABLE program were disappointing, the decision to halt the Rikers SIB has been hailed by some as evidence of the

²² See Izzy Boggild-Jones & Emily Gustafsson-Wright, *A global snapshot: Impact bonds in 2018* (2019), <https://www.brookings.edu/blog/education-plus-development/2019/01/02/a-global-snapshot-impact-bonds-in-2018/> (providing database that includes 127 social impact bonds and 7 development impact bonds. More than 25% of these 134 impact bonds had reached their maturity (most of these were U.K. SIBs) and repaid investors their invested capital and a positive financial return).

²³ *Id.*

²⁴ See generally John Olson & Andrea Phillips, *Rikers Island: The First Social Impact Bond in the United States*, COMMUNITY DEVELOPMENT 97–98 (2013), <https://www.frbsf.org/community-development/files/rikers-island-first-social-impact-bond-united-states.pdf> (Goldman Sachs representatives describing Rikers SIB structure).

²⁵ *Id.*

²⁶ *Pay for Success*, *supra* note 19, at 5.

²⁷ *Id.* at 3 (showing that, while Goldman was able to recoup much (75%) of its invested capital by drawing on the Bloomberg guarantee, Goldman did not receive any success payments).

transaction's success, albeit a different kind of success than that of the Peterborough SIB. Namely, the Rikers SIB successfully transferred the risk of funding ineffective social interventions from the government contracting authority to the SIB investor and the SIB investor's guarantor.²⁸

The early terminations of these two SIBs—Peterborough and Rikers—highlight the challenges that can confront transactions of this ilk. They also illustrate how difficult it can be to structure deals that durably align interests across a range of actors from the private sector and public sector. Yet, in spite of these challenges, the number of SIB deals continues to grow in the United States, although more slowly than early enthusiasts may have hoped.²⁹

II. EMPTYING BEDS: WHAT PROBLEMS DO SIBS SEEK TO FIX

Researchers at the Urban Institute estimate that over half of the social services provided in the United States are channeled through public-private partnerships whereby government funding reaches intended beneficiaries through service providers that are organized as not-for-profit organizations.³⁰ Contractual incentives have long been incorporated into these public-private partnerships—often in the form of a range of performance rewards.³¹ These performance rewards have evolved over time.

²⁸ See, e.g., Daniel Barker et al., *Paying for Results: Reforming How the Public Sector Funds Social Services*, in WHAT MATTERS: INVESTING IN RESULTS TO BUILD VIBRANT STRONG COMMUNITIES 68, 75 (2017) [hereinafter WHAT MATTERS] (stating that the “failure” of the first pay for success initiative in the United States actually demonstrates benefits of pay for success financing as the government did not have to pay for interventions that did not work and, instead, could channel government resources to other uses); MDRC, *MDRC Statement on the Vera Institute’s Study of the Adolescent Behavioral Learning Experience (ABLE) Program at Rikers Island* (July 2015), <https://www.mdrc.org/news/announcement/mdrc-statement-vera-institute-s-study-adolescent-behavioral-learning-experience> (“While it is disappointing that the program did not meet its goals, the Social Impact Bond financing arrangement worked as it was supposed to . . . Because the program did not meet the impact requirements, the City is not paying for a program that did not produce results—a positive outcome for the City and taxpayers.”).

²⁹ The pace of SIB launches picked up in 2017 in the United States (number of U.S. SIBs since first SIB was launched in United States in 2012: 2012 (1), 2013 (2), 2014 (4), 2015 (1), 2016 (4), 2017 (8), and 2018 (6)). See NONPROFIT FINANCE FUND, *PFS-Project Matrix*, http://www.payforsuccess.org/resources/?facets%5B0%5D=material_type%3A640&facets%5B1%5D=material_type%3A641&facets%5B2%5D=material_type%3A642&facets%5B3%5D=material_type%3A643&sort=date, (last visited Feb. 18, 2019) [hereinafter Nonprofit Finance Fund SIB Database].

³⁰ Emily Gustafsson-Wright, *Performance-Based Contracting Can Provide Flexibility, Drive Efficiency, and Focus Resources on What Work in Social Services*, in WHAT MATTERS 57 (citing article by Elizabeth Boris et al., *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants*, URBAN INSTITUTE (2010), <https://www.urban.org/research/publication/human-service-nonprofits-and-government-collaboration-findings-2010-national-survey-nonprofit-government-contracting-and-grants>) [hereinafter Boris et al.].

³¹ Boris et al., *supra* note 30, at 13.

Sometimes government agencies simply contract for work based on performance outputs. Other times, government agencies base their decisions about whether to renew a contract according to whether desired outcomes previously were reached by the contracted party. And, more recently, some government actors scale contract payments according to degrees of performance—measured by outputs, outcomes, or some combination of the two.³²

When seen through this historical lens, one might argue that SIBs are a natural variation on the social service contractual relationships being forged among public and private actors. Or, as others have put it, the SIB structure in the United States, with its reliance on pay for success contracting, is an overnight sensation that was “50 years in the making.”³³ That is to say, SIBs, at least as they have emerged in the United States, are in many ways a natural evolution of what has come before in the area of government contracting for social services.³⁴

What then is new about SIBs? As SIB champions are likely to tell you, SIBs are unique in that they draw on three powerful trends: (1) reliance on data and evidence in government policymaking, (2) use of capital markets to do good in society, and (3) creation of social service delivery models that align interests of public and private actors in new forms of public-private partnerships.³⁵

Even enthusiasts for SIB transactions recognize, however, that the SIB structure (and other forms of outcomes-based commissioning) is not a suitable approach for addressing every so-called “wicked” social problem.³⁶ So, when and where is this form of government contracting

³² Gustafsson-Wright, *supra* note 30, at 61 (outlining, via chart, federal government policy from 1960–2016).

³³ Andrea Levere, *The Measures of a Movement: Investing for Results Now and Tomorrow*, in *WHAT MATTERS* 457, <https://investinresults.org/chapter/measures-movement>.

³⁴ A similar trajectory can be mapped even further back in history in the U.K. Government contracting that incorporates payment by results dates to the Victorian age in England. See ALBERTSON ET AL., *supra* note 12, at 6.

³⁵ See, e.g., Tracy Palandjian, *Financing Outcomes Through Social Impact Bonds*, in *WHAT MATTERS* 149, <https://investinresults.org/chapter/financing-outcomes-through-social-impact-bonds>. Others would add to this list the emergence of a public service reform agenda, such as that taking place in the U.K., which is turning increasingly to outcomes-based commissioning. See *also id.*

³⁶ Horst Rittel first coined the term “wicked problems” to capture entrenched, complex, and multifaceted social problems that have been largely impervious to solutions attempted by government policies or programs. These social problems are exceedingly difficult to solve due to a variety of reasons—ranging from multiple explanations about the causes of the problem, the interconnected nature of these problems as symptomatic of *other* problems, the lack of a tried and true path for guiding problem-solving, hard-to-measure inroads (including success) in addressing a wicked problem, and so on. Horst Rittel & Melvin M. Webber, *Dilemmas in a General Theory of Planning*, 4 *POLICY SCIENCES* 155–169 (1973); see also JON KOLKO, *WICKED PROBLEMS: PROBLEMS WORTH SOLVING* (2012).

most appropriate?³⁷

One revealing line of inquiry for ascertaining the suitability of a SIB is to ask first whether a successful intervention is likely to prevent the targeted social ill. Then, if so, would the prevention of this social ill result in the reduction of observable (and quantifiable) costs that otherwise would be borne by the government?³⁸

The preventative gains (societal and financial) of effective SIBs are most graphically demonstrable in cases where the interventions paid for by the SIBs result in emptying beds that otherwise would be filled. There can be significant budgetary savings and societal benefits when beds are emptied—prison beds, homeless shelter beds, hospital beds, or foster care beds, to name a few—so long as the underlying root problems that made the bed necessary in the first place are addressed.³⁹ Accordingly, it should not be surprising that nearly half of the SIBs taking place from 2012 through 2017 in the United States have focused on creating interventions that involve beds in some form—criminal justice issues (5 transactions) and housing/homelessness issues (4 transactions).⁴⁰

The U.S. experience with using SIBs to prevent thorny social problems mirrors in many respects what is happening globally. According to Social Finance, the 130 SIBs that have been launched in the world as of January 2019 aim to address the following social problems: workforce development (40), housing/homelessness (23), health (22), child and family welfare (20), criminal justice (21), education and early childhood development (11), and poverty and environment (3).⁴¹ All of

³⁷ ALBERTSON ET AL., *supra* note 12, at 29.

³⁸ The administrators of SIPRA funding are wrestling with this as they try to describe the amount of outcome payments that the federal government will fund under SIPRA. Generally, SIPRA grants can be used to make outcome payments if an independent evaluator determines that 1) the project achieved a specific outcome as a result of intervention and 2) payment is less than or equal to “value of outcome” to the federal government. This outcome valuation then is described as “the public benefit resulting from achieving the outcome target(s), including public sector savings (defined as reduction in outlay costs) and changes in federal tax receipts. The [f]ederal payment to the State or local government for each specified outcome achieved as a result of the intervention must be less than or equal to the value of the outcome to the [f]ederal [g]overnment over a period not to exceed 10 years” See NOFA, *supra* note 17, at 9, 11–12; *see also* § 1397n-2(c)(1)(B).

³⁹ Yet, adequate precautions still may need to be taken to ensure that those being turned out of beds are actually no longer in need of them. It does not take a particularly vivid imagination to foresee service providers engaging in opportunistic behaviors in order to empty more beds or improve the count of emptied beds. *See* ALBERTSON ET AL., *supra* note 12, at 24 (observing that outcomes-based commissioning can increase gaming behaviors by social service providers. This can take a variety of forms from “cherry-picking” cases that are most likely to benefit from a service to “parking” hard cases outside of the beneficiary cohort).

⁴⁰ *Pay for Success*, *supra* note 19, at 3. Other issues that have been the focus of SIBs in the United States include: education/early years, children and family welfare, health, environment and sustainability, and workforce development.

⁴¹ *See* Social Finance Impact Bond Database, *supra* note 3.

these are big and complex problems—deserving of their “wicked” moniker. Similarly, the societal gains that come from preventing these problems can be significant and can lead to significant savings—financial and otherwise.⁴²

Another important line of inquiry to determine the suitability of SIBs is to consider whether the contractual arrangements that support SIBs can effectively address the policy objectives of the public sector while also aligning incentive structures to attract private sector investments.⁴³ The following discussion focuses on the emerging architecture of pay for success contracts used for SIBs transacted in the United States.

⁴² Assigning a dollar figure on these savings, however, is not easy. In part, this challenge is due to the different “discount rates” likely to be applied by public and private actors as they calculate the present value of the costs and benefits of funding social interventions that generate future desirable outcomes (some of which may result in political benefits, not financial savings) and possible budgetary savings. *See generally* ALBERTSON ET AL., *supra* note 12, at 19 (recognizing that policy objectives of outcome-based commissioning often include reducing costs of providing public services or increasing efficiency in their delivery, but also recognizing this objective may not always be “cashable”); *see also* NOFA, *supra* note 17, at 6, 31 (stating that funding applications under SIPRA should include an estimation of savings to the federal government and other project savings to the extent not otherwise included in the outcome valuation to be generated for governments (federal, state, and local) if outcome indicators are achieved); *see also* U.S. DEP’T OF TREASURY, OMB No. 1505-0260, SIPRA OUTCOME VALUATION ATTACHMENT TEMPLATE (2019).

While not the focus of this Article, a rich area for future economic and legal analysis would be to analyze the outcome payment terms of SIBs in the United States and beyond. For example, to what extent does the size of outcome payments being made by public sector actors to private sector investors in SIBs reflect a transfer of the difference between the presumably lower public sector discount rate that government actors would assign to the costs and benefits of financing a particular social intervention and the presumably higher discount rate that is likely to be applied by private sector investors to the same project? Similarly, to what extent does the imposition of a “cap” on the amount of government outcome payments dissuade potential SIB investors who fear the downside risk of receiving little to no outcome payment without an equally commensurate upside? *See generally* ALBERTSON ET AL., *supra* note 12, at 25 (stating that since the for profit sector is likely to be significantly more risk averse than government, higher outcome payments may be required to “induce the private sector to take on government risk”).

Related, are observable differences within the private sector’s financial return expectations and risk appetites for SIBs explainable by the nature and sources of funding of the particular type of private sector actor? For example, do the risk/return expectations of a financial institution investing in a SIB vary in predictable ways from that of a philanthropic entity investing in a SIB? As more SIBs are transacted, more discernible patterns of investor behavior in SIBs may emerge. One recent step in this research direction can be found in the analysis conducted by Alfonso Del Giudice and Milena Migliavacca of the apparent preferences of institutional investors for certain financial and contractual structures when investing in SIBs. Alfonso Del Giudice & Milena Migliavacca, *Social Impact Bonds and Institutional Investors: An Empirical Analysis of a Complicated Relationship*, 48 *NONPROFIT AND VOLUNTARY SECTOR Q.* 50, 65 (2019).

⁴³ ALBERTSON ET AL., *supra* note 12, at 29 (pointing out need to carefully consider policy objectives, some of which may conflict, and incentive structures when designing contractual arrangements for SIBs).

III. BLANK SHEETS OF PAPER

A. *Where Pay for Success Contracts Started*

Navjeet Bal, General Counsel of Social Finance, tells the story that when she sat down to draft her very first pay for success contract, she started with a blank sheet of paper.⁴⁴ Those handy tools found in every deal lawyer's toolbox—precedents and form contracts—were nowhere to be found for drafters of the earliest SIBs in the United States. Ms. Bal, however, had a municipal bond background. And, while most SIBs are not structured as bonds,⁴⁵ her municipal bond practice provided Ms. Bal with a starting point for thinking about how to create a contract that attracts financing from private investors to fund social services contracted by the government.

Beyond simply memorializing the terms and goals of the parties to pay for success contracts, lawyers, like Ms. Bal, who were tasked with drafting these early contractual arrangements had significant structural as well as documentation issues to consider. For example, how much flexibility, if any, should be built into these contractual arrangements? How much time and attention should be paid to “negotiating the corners,” that is, identifying and providing courses of action to respond to the myriad of circumstances that might pose challenges or hurdles to reaching the desired social and financial outcomes of these transactions? If circumstances unexpectedly change during the term of these arrangements (as they often do), who should get a say in exercising residual rights of control in responding to these uncontracted-for circumstances? Does it matter who gets these decision-making rights? Are the interests of (and incentives available to) those decision-makers appropriately aligned with the policy goals of the transaction?

⁴⁴ Interview at Global Impact Investing Network's Legal Practitioners Track Annual Workshop with Navjeet Bal, General Counsel, Social Finance, in New York, N.Y. (on Nov. 3, 2017).

⁴⁵ As of January 2019, only one U.S. SIB had been issued in the form of a municipal bond—the DC Water's Environmental Impact Bond. *See* Beth Bafford et al., *Investing in Innovation and Outcomes: The Story of DC Water's Environmental Impact Bond*, in *WHAT MATTERS* 228–31 (stating that in September 2016, DC Water issued a \$25 million bond in a private placement to Calvert Foundation and Goldman Sachs Urban Investment Group. Unlike most municipal bonds where investors generally look to the creditworthiness of the municipal issuer for assurances of receiving a financial return, this tax-exempt municipal security's financial returns are linked to the extent to which the volume of stormwater runoff is reduced). To confuse this bond/not bond discussion further, in spite of the fact that SIBs typically are not structured as bonds, the impact bond terminology persists—albeit in shape-shifting form. For example, in addition to SIBs, there are now DIBs (development impact bonds), HIBs (humanitarian impact bonds), and EIBs (environmental impact bonds like that issued in D.C.). Watch this space as there are likely more variations in the impact bond lexicon to come.

B. *What Pay for Success Contracts Look Like Now*

As the number of SIB deals in the United States has grown, those structuring SIBs and the lawyers charged with documenting these transactions have benefited from a repository of SIB deal documentation created by the Nonprofit Finance Fund.⁴⁶ Even though the repository does not involve every SIB deal in the United States nor all SIB-related contracts for these deals (for example, the funding agreements of SIB investors are often not shared publicly), the availability of a significant number of pay for success contracts has contributed to a knowledge sharing that benefits all involved. Most applicable for this discussion, lawyers charged with drafting the contractual arrangements for SIBs can now see how prior pay for success contracts were structured and how recurring issues have been addressed contractually across multiple SIB transactions.

While the laws and regulations of each jurisdiction where a SIB is transacted will give rise to differences in the contractual frameworks being adopted and in some cases, the very contract terms that are required by state legislation to be included in a pay for success contract,⁴⁷ the architecture of pay for success contracts is beginning to take recognizable form in the United States—even as these transactions cross state, county, and municipal/city jurisdictional lines. So, although the business terms of the SIB transactions may differ significantly from one deal to another, a reader of the pay for success contracts for these SIBs is likely able to find many of the same key topics handled by each contract, often in the very same order from deal to deal.⁴⁸

This suggests that the lawyers involved in drafting the contractual arrangements for U.S. SIBs are borrowing from, and where appropriate,

⁴⁶ See Nonprofit Finance Fund SIB Database, NONPROFIT FINANCE FUND, <https://www.payforsuccess.org/projects/>.

⁴⁷ AMY COBB CURRAN, *Inroads to Innovation: State Adoption of Pay for Success Legislation* 12–14 (2017) [hereinafter STATE P-F-S LEGISLATION]. Curran observes that although state legislation in the United States varies in degree of specificity as to the contract terms required to be included in the pay for success contracts that support SIBs, there are certain topics that state legislatures commonly require to be addressed in the pay for success contracts for SIBs taking place in their jurisdictions. These include terms specifying that government payments are conditioned on the SIB program's success, clear processes and metrics by which outcomes are to be measured by an independent party, and sources and the extent of budgetary savings that could be realized if the SIB program succeeds. See, e.g., MASS. GEN. LAWS ch.10, § 35VV (2012); COLO. REV. STATE. ANN. § 24-37-402(3) (2015); TEX. GOV'T CODE § 403.110 (2015); CAL. GOV'T CODE § 97011 (2015); OKLA. STAT. ANN. TIT. 57 § 510.8c (2014); IDAHO CODE ANN. § 33-125B(5); ARK. CODE ANN. § 12-27-204 (2015) (requiring terms that specify role and/or processes by which outcome measurements are to be determined by an independent evaluator); see also MASS. GEN. LAWS ch. 10, § 35VV (2012); CAL. GOV'T CODE § 97011(4) (2015) (requiring terms that describe budgetary savings to be realized by state if SIB program is successful).

⁴⁸ See *infra* note 50.

replicating approaches taken in prior deals.⁴⁹ Or, at the very least, these lawyers are looking to prior deals to spot issues that need to be addressed by parties to pay for success contracts. This is in marked contrast to the challenges facing those who documented the first SIB deals launched in the United States.

Pay for success contracts created in the United States increasingly are organized as follows:⁵⁰

- I. *Term of contract* (describes whether there is a pilot period; sets the launch date; describes the duration of the contract);
- II. *Program and performance indicators* (describes the social issue(s) to be addressed; specifies service interventions to be undertaken; establishes performance indicators—outcomes and outputs);
- III. *Funding and outcome payments* (describes the sources, timing, and nature of funding to be made by investors; describes sources, conditions, and timing of outcome payments);⁵¹
- IV. *Oversight and reporting* (describes the contractual governance structures being used to oversee the operations of the transactions—such as what oversight/operational committees are being established, their composition, how often they meet, their decision-making authorities, and how votes are counted (unanimity/consensus or do certain

⁴⁹ Access to a database of these early pay for success contracts was likely very helpful to the lawyers charged with drafting these agreements given their novelty. Of the first 10 SIBs conducted in the United States only three law firms worked on more than one of these deals. *See Pay for Success, supra* note 19, at 8. As the number of SIBs has increased in the United States, so too has the number of lawyers who have developed expertise in negotiating and drafting the contractual arrangements for a variety of SIBs. Now, it is much more likely that at least one or more of the lawyers at the table (in-house or outside) have had some experience in negotiating and documenting prior SIB transactions and can bring that expertise and experience to bear on these more recent deals.

Another important factor that may be contributing to the adoption of similar contract provisions and approaches in U.S. SIBs is the presence of repeat players in the form of project managers, intermediaries, and advisors, such as Social Finance, Third Sector Capital, and the Government Performance Lab at Harvard University.

⁵⁰ These observations are based on the author's review of pay for success contracts that have been made available publicly through the U.S. SIB database created by the Nonprofit Finance Fund. It also draws heavily on the comparative analysis conducted in late 2015/early 2016 by Dana Archer-Rosenthal of the first 10 SIBs contracted in the United States. *See generally Pay for Success, supra* note 19.

⁵¹ As noted above, the investors' funding agreements are often not made public. However, some of the pay for success contracts that are publicly available in the United States include, as a schedule to these contracts, term sheets specifying key financial terms of the funding to be provided by the SIB investors and grantors.

- parties have rights to override others' interests); also describes reporting requirements and responsibilities (interim and at end of project));
- V. *Representations and covenants of key parties* (intermediary, government payor, and possibly social service provider or coordinator of social services);
 - VI. *Termination rights; remedies; and wind-down procedures* (who decides if the SIB should be terminated early; the grounds for termination; whether termination must be for cause or not; how transactions will unwind (if outcome payments have been allocated by the outcome payer but not yet disbursed to parties, how will these be paid and who pays for wind-down costs)); and
 - VII. *Amendment; dispute resolution mechanism; miscellaneous matters* (such as assignment rights, governing law, etc.).

Within these topical areas, however, the content of these contractual provisions often differs from deal to deal, sometimes significantly so. This should not be surprising given that the goals, business terms, and parties to SIB transactions vary greatly. Moreover, SIBs continue to evolve.⁵²

Yet, one feature found in nearly all of these pay for success contracts endures—that is, the inclusion of a contractual governance or oversight structure (see Article IV above).⁵³ This likely would not surprise Nobel Laureate Oliver Hart whose work explains how parties are likely to contract when facing a world of uncertainty and incomplete knowledge.

⁵² Palandjian, *supra* note 35, at 153–54 (stating that since the first SIB was launched in Peterborough in 2010, SIBs have changed across range of dimensions such as financial structures, payor characteristics, measurement and evaluation approaches, and transaction goals).

⁵³ Unlike some contract provisions mandated by state legislatures, see *supra* note 47, contractual governance and oversight structures appear to have been voluntarily introduced by the parties to these pay for success contracts. From the very beginning, pay for success contracts in the United States have included such governance and oversight structures, starting with the Rikers SIB that was launched in 2012. See *Pay for Success*, *supra* note 19, at 21 (stating that of the first nine SIBs contracted in the United States for which public data is available, all nine included such structures).

IV. INSIGHTS OF A NOBEL LAUREATE: HOW INCOMPLETE
CONTRACTING INFORMS THE DESIGN OF
PAY FOR SUCCESS CONTRACTS

Nobel Laureate Oliver Hart's ground-breaking work in the field of incomplete contracting provides a theoretical construct for shedding light on the introduction of contractual governance and oversight structures found in pay for success contracts.⁵⁴ He has observed that a contract is complete only when it differentiates among all relevant future states of the world and a third party (like a court) can verify, when necessary, which state has occurred.⁵⁵ In those instances where it is not feasible to describe all actions available to a manager or all states of the world, the contract is necessarily incomplete.⁵⁶

This incomplete contract framework has had many applications since first articulated by Hart and his colleagues in 1986. Originally, the framework was developed to answer the question of what is a firm, and in doing so, to explain why so many transactions take place *within* firms as opposed to *between* firms. Since its original application, this framework has been applied to far-ranging fields such as corporate finance, industrial organization, international trade, and political economy, to name a few.⁵⁷

The incomplete contracting framework explains (and identifies) the benefits and costs of vertically integrating a firm as opposed to contracting with other firms. In Hart's model, there are two principal ways that a long-term relationship between two firms can be conducted.⁵⁸ They can remain as independent firms and engage in an arm's length contract. Or, they can merge and carry out transactions within a single firm.

To determine which relationship is optimal—an arm's length contract or a transfer of ownership—it matters whether the relationship is taking place in a complete contracting world or an incomplete contracting world. In a complete contracting world, ownership is not neces-

⁵⁴ In 1986, Sanford J. Grossman and Oliver Hart published *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration* in the *Journal of Political Economy*. Four years later, Oliver Hart and John Moore co-authored *Property Rights and the Nature of the Firm*, which was also published in the *Journal of Political Economy*. Together those two papers constitute what is often called "GHM Property Rights Theory."

⁵⁵ Karen Eggleston, Eric A. Posner & Richard Zeckhauser, *Design and Interpretation of Contracts*, 95 *Nw. U. L. Rev.* 91, 100 (2000).

⁵⁶ *Id.*

⁵⁷ See generally THE IMPACT OF INCOMPLETE CONTRACTS ON ECONOMICS (Phillippe Aghion et al. eds. 2016) (a collection of presentations and discussions that took place at a 2011 conference celebrating the 25th anniversary publication in 1986 of Grossman and Hart's article that described the incomplete contract framework).

⁵⁸ Oliver Hart, *Incomplete Contracts and Public Ownership: Remarks, and an Application to Public-Private Partnerships*, 113 *ECON. J.* C69 (2003).

sary to control the parties' behavior because everything can be detailed *ex ante* in the initial contract. In contrast, in an incomplete contracting world, ownership matters a lot because ownership is a gap-filler for all those issues that cannot be addressed in the contract *ex ante*. Put differently, the owner of an asset will make those decisions concerning its assets that have not been specified in the initial contract.⁵⁹

So how do Hart's insights about the optimal vertical integration of firms pertain to decisions about how to contract for SIBs? While his insights predate the creation of SIBs by 25 years, Hart used an incomplete contracting framework to explore the optimal boundaries between the roles of the public and private sectors.⁶⁰ Similarly, Hart's incomplete contract theory also offers insights as to how contracts are likely to take shape when the state of the world in which they must function is incomplete. In both instances, this is exactly the terrain that the creators of pay for success contracts for SIBs are exploring.

A. *Role of Private vs. Public Sector in Delivering Social Services that Meet Desired Outcomes*

Hart has observed that, not unlike private firms, governments also must make decisions about when to vertically integrate by ownership (that is, create the capacity within a government agency to provide social services) or by contract (that is, contract for social services on an arm's length basis from a provider outside the government). In his 2003 article, "Incomplete Contracts and Public Ownership: Remarks, and an Application to Public-Private Partnerships,"⁶¹ Hart turns to incomplete contract theory to shed light on whether the government needs to *own* a service provider to control the service provider's behavior or whether there is a case to be made for the government to *contract* with a service provider for desired social services.

As with his analysis of the vertical integration of firms, Hart opines that "in a complete contracting world the government does not need to own a firm to control [the firm's] behaviour: any goals—economic or

⁵⁹ Typically, as in Hart's framework, the owner of a noncontracted asset retains decision-making authority with respect to that asset. These residual decision-making rights (or lack thereof) can provide powerful incentives and disincentives to the parties that have entered into an incomplete contract. Simply put, giving decision-making authority (e.g. control over an asset) to one agent improves that agent's incentive to invest, but it also is likely to reduce the investment incentives of others. See, e.g., Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. OF POL. ECON. 691, 695–700 (1986) (providing a full explanation of Grossman and Hart's model).

⁶⁰ The following discussion draws heavily on Hart's article, *supra* note 58, and an earlier article that he co-authored. See Oliver Hart, Andrei Shleifer, and Robert W. Vishny, *The Proper Scope of Government: Theory and Application to Prisons*, 112 Q. J. ECON. 1127 (1997).

⁶¹ Hart, *supra* note 58.

otherwise—can be achieved via a detailed initial contract.”⁶² But Hart also recognizes that it is very difficult to create a complete contract for the provision of social services. Consequently, governments are likely to be operating in a world where “it is hard to foresee and contract about the uncertain future False.”⁶³

Hart then asks whether insights from analyzing the costs and benefits of vertically integrating a firm in an incomplete contracting world can be applied to questions of when a government actor, also operating in an incomplete contracting world, should privatize (take ownership of) a social service provider or contract with such providers for the desired social services. He posits that firm ownership (and related residual decision-making rights) over non-contracted assets will encourage greater investing by the owner and gives the owner “greater bargaining power when uncontracted-for contingencies arise.”⁶⁴

Does this also hold true for government ownership? More specifically, does government ownership lead to more investments in ideas (or entrepreneurial problem-solving) by government bureaucrats than would be undertaken by private sector contractors? Hart concludes that greater government ownership is unlikely to stimulate greater government investments in innovative solutions.⁶⁵ In contrast, Hart surmises that private ownership is likely to encourage more innovative investments than does government ownership. But there is a trade-off that comes with the innovations that may be spurred by private ownership, he warns. Private ownership also may encourage quality-shading investments even as the private actor operates “within the letter of the contract.”⁶⁶ Consequently, Hart concludes that procurement contracts play a “crucial” role in this context because these contracts between contracting government agencies and external, private service providers define “the extent to which quality shading can occur.”⁶⁷

This conclusion is similar to that reached by Hart and his co-authors in an earlier article that evaluated the benefits and costs of privatizing prisons.⁶⁸ In that prison privatization article, Hart and his co-authors theorized that where government contracts with external contractors are incomplete, the external contractor has stronger incentives to engage in

⁶² *Id.* at C70.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ Hart is not alone in reaching this conclusion. Recently, some have extended this conclusion directly to SIBs. *See, e.g.,* Alexander Volokh, *Prison Accountability and Performance Measures*, 63 EMORY L. J. 339, 403 (2013) (suggesting that SIB intermediaries and philanthropic investors are probably better at monitoring prison staff than government bureaucrats would be).

⁶⁶ Hart, *supra* note 58, at C71.

⁶⁷ *Id.*

⁶⁸ Hart et al., *supra* note 60.

both quality improvements and cost reductions than does a government employee. Yet, they recognize that the external contractor's financial incentive to reduce costs may be so strong that the contractor will pursue cost reductions at the expense of delivering non-contractible quality.⁶⁹

Accordingly, Hart ends up concluding that government contracting with external providers for social services (or, as he puts it, engaging in a public-private partnership (PPP)) is an optimal option where either the quality of social services can be detailed in the initial contract or there are good performance measures that can be used to reward or penalize the service provider.⁷⁰ He qualifies this conclusion, however, by noting that it may be harder to specify quality standards for certain types of social services than others. Hence, where the quality of services cannot be fully described or defined in the procurement contract, it may be more appropriate to regulate the procurement of such services by having the government retain or secure ownership rather than contract with external providers.⁷¹ This analysis goes to the heart of when it is most appropriate to transact a SIB. Following Hart's logic, SIB transactions also should be optimal only in those situations where quality and related performance measurements can be described *ex ante* in the pay for success contract.

Fast forward thirty some years from Hart's examination of the costs and benefits of prison privatization to February 2019 and the implementation of SIPPPRA by the U.S. Government. Those charged with administering the SIPPPRA grants to be used for outcome funding appear to be playing by Hart's rulebook. Note how they describe the foundational importance of fully describing and coming to agreement about outcome indicators *ex ante*:

An outcome is a positive impact on a target population that an applicant expects to achieve as a result of an intervention over the duration of a project. An outcome is measured by one or more indicators that are specific, unambiguous, and observable during the intervention period. Well-defined, achievable, and measurable out-

⁶⁹ *Id.* The debate over the costs and benefits of privatized prisons rages still today. See, e.g., *Justice Department Will Again Use Private Prisons*, WASH. POST (Feb. 23, 2017), https://www.washingtonpost.com/world/national-security/justice-department-will-again-use-private-prisons/2017/02/23/da395d02-fa0e-11e6-be05-1a3817ac21a5_story.html (reporting that Attorney General Sessions reversed an Obama Administration directive to reduce or decline to renew contracts with private prison operators); see also Memorandum from Deputy Attorney Gen. Sally Q. Yates, "Reducing our Use of Private Prisons" (Aug. 18, 2016) (directing reduction and nonrenewal of contracting with private prison operators citing lack of quality in services and no appreciable cost savings).

⁷⁰ Hart, *supra* note 58, at C74.

⁷¹ *Id.* (contracting on building schools and prisons may be relatively simple, while contracting on services may not; in contrast, it may be easier to design performance measures for patient treatment in hospitals than to create specifications for a hospital building).

comes from the foundation of the pay for results concept. Whether suitable outcome targets (also referred to as outcome goals) can be identified and agreed upon by the partnership is a key determinant of whether pay for results is the appropriate instrument for addressing the identified social issue.⁷²

SIBs, by design, attempt to introduce a brake on cost-reducing tendencies that could lead to quality shading behaviors by external contractors delivering social services. This can take several forms. First, there is the mission-driven nature of many social service providers. In the United States, the social service providers engaging in SIBs are often organized as nonprofit organizations⁷³ and, therefore, are required to act in furtherance of their charitable purposes. Moreover, the service provider's reputation is at stake. A very public failure in serving intended beneficiaries may have significant consequences not only for the SIB transaction at hand, but also on the service provider's ability to attract future funding.

But SIBs do not stop there. Not only are the government outcome payor and social service provider(s) focused on determining whether outcomes meet quality objectives specified in the SIB documentation,⁷⁴ but SIBs invite to the table a third party that also has a stronger financial interest in improving the effectiveness of social services (that is, delivering quality as specified by the contracted outcome objectives) than in reducing the costs of delivering such services. That third party is the SIB investor whose very financial returns depend upon outcome indicators being achieved. Consequently, the SIB investor will be keen to ensure that the social service provider acts in a manner that is likely to reach specified outcome indicators so that the SIB investor receives its contracted success/outcome payments from the government outcome payor. This presumed alignment of the SIB investor's financial interests with the government contracting authority's public policy interests is intended to add a layer of accountability missing from Hart's understanding of how governments contract for social services in more traditional public-private partnerships.⁷⁵

⁷² NOFA, *supra* note 17, at 10.

⁷³ See *Pay for Success*, *supra* note 19; but see *infra* note 102.

⁷⁴ It is here that some may argue that the government outcome payor actually has a perverse incentive to see the social service provider just miss the outcome indicators, such that much good is done but not so much that the government outcome payor has to pay for those services.

⁷⁵ Even this seeming alignment can be distorted, particularly if the evaluation process and metrics are not well-designed. This was a criticism lodged at the Utah SIB aimed at providing a "high quality preschool program." Its early interim results showed that within the first cohort of 110 beneficiaries who were four years-old at the program's start and who tested as "likely to need special education services," only one student required special education services after the end of the students' kindergarten year. As a result, its senior investor, Goldman

As discussed below, it is an open question as to whether SIB investors can and do influence the behavior of social service providers in SIB transactions. Accordingly, not only does Hart's incomplete contract framework provide guidance about which social services are best suited to SIB financing, his framework also suggests the importance of creating governance and oversight mechanisms in pay for success contracts that effectively hold parties accountable for their behavior during the term of SIBs.

B. Contractual Governance and Oversight in the Incomplete World of SIBs

As should be clear by now, the pay for success contracts used in SIB transactions are likely to be functionally incomplete in that they cannot begin to articulate every challenge or issue that may arise during their term and the consequences of those unforeseen or undescribed circumstances. Compounding the challenges of creating an effective pay for success contract is the extended length of these contractual relationships, some of which may run for a dozen or more years before final outcome evaluations are conducted and last outcome payments, if any, are made to SIB investors.⁷⁶

SIB contracts, of course, are not unique in their incompleteness.⁷⁷ All contracts are functionally incomplete to some extent. Public-private partnership contracts are often especially incomplete, however, particularly when compared to private-private contracts or public-public con-

Sachs, received an interim repayment that was based on the budgetary savings per student. This extraordinarily high reduction in the need for special education services raised questions about the validity of the evaluation method, project costs, and appropriateness of outcome metrics. See *Social Impact Bonds for Early Childhood Education in Utah*, Centre for Public Impact, (April 7, 2017), <https://www.centreforpublicimpact.org/case-study/social-impact-bonds-early-childhood-education-utah/>; see also Nathaniel Popper, *Success Metrics Questioned in School Program Funded by Goldman*, N.Y. TIMES (Nov. 3, 2015, <https://www.nytimes.com/2015/11/04/business/dealbook/did-goldman-make-the-grade.html>) (suggests that Goldman and Utah significantly overstated effect SIB program had on helping children avoid special education services).

⁷⁶ *Id.* at 16. The scheduled duration of SIBs in the United States have run as long as 17 years, although some are as short as four years.

⁷⁷ In this regard, one apt analogy to SIB contracts are venture capital contracts. When parties enter into venture capital contracts, they typically specify some but not all future outcomes. As a result, ownership and associated contingent control allocations substitute for comprehensive contract terms. See, e.g., William M. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 893–902 (2002) (examines how to apply incomplete contract theory to capital structures such that capital structure aligns incentives so that optimal investments and management take place by ensuring that actor with most appropriate incentives controls company's assets).

tracts.⁷⁸ Like the contracts used for other long-term, public-private partnerships, the pay for success contracts found in SIBs are similarly incomplete.

Although a complete contract is theoretically optimal, this first-best outcome is rarely, if ever, achievable in the real world, and certainly is not achievable in the uncertain, complex, and ever-changing world where SIB transactions typically take place. Accordingly, when confronting such a world, parties are likely to search instead for a second-best optimality that balances transaction costs against losses due to contract inefficiency.⁷⁹ This balancing act may cause parties to opt for an incomplete contract, particularly if transaction costs appear likely to overwhelm the value of contract efficiencies.⁸⁰ Practically, this means that contracting parties will choose to make better use of their time negotiating the terms of contractual oversight processes and decision-making authorities rather than attempting to plan for and address an endless range of scenarios that might derail the transaction's desired outcomes. That, as Hart and his fellow incomplete contract theorists may have predicted, is what appears to be happening in the pay for success contracts being crafted for the SIBs taking place in the United States. Namely, as lawyers (and their clients) have gained more insight into the range of factors that can derail or slow a SIB transaction from delivering on its promise, they have turned to creating contractual governance and oversight bodies that are charged with responding to the myriad of potential complications and challenges that a SIB is likely to face over its duration.

V. ANALYSIS OF CONTRACTUAL GOVERNANCE AND OVERSIGHT STRUCTURES BEING USED IN U.S. PAY FOR SUCCESS CONTRACTS

The lawyers tasked with negotiating and penning a pay for success contract that supports the creation of a governance or oversight structure have no easy task—even with precedents that can serve as models. One of the more challenging issues is to figure out how best to coordinate the actions of a diverse set of actors with multiple agendas and shifting perspectives—government policymakers, private investors, and social service providers—over a long period of time, while also crafting agreed

⁷⁸ See generally Martijn Van Den Hurk & Koen Verhoest, *The Challenge of Using Standard Contracts in Public-Private Partnerships*, 18 PUB. MGMT. REV. 278, 279–82 (long-term infrastructure PPP contracts typically require parties to contract incompletely).

⁷⁹ Eggleston et al., *supra* note 55, at 103–04.

⁸⁰ Houman B. Shadab, *Performance-Sensitive Debt: From Asset-Backed Loans to Startup Financing*, 16 U. PA. J. BUS. LAW, 1077, 1100–01 (2014). “Negotiations costs” lead parties to rationally enter into legally enforceable contracts that are full of gaps because negotiation costs exceed additional value that more functionally-complete contract would confer on the parties. Eggleston et al., *supra* note 55, at 107–08.

upon processes by which these contracting parties will respond to both anticipated and unanticipated consequences of scaling effective social service interventions in a changing and uncertain world.⁸¹ In short, when parties are engaged in incomplete contracting, one crucial task of lawyers negotiating and documenting a pay for success contract is to create a workable oversight structure for decision-making over the life of the SIB for those issues that have not been contracted for and to ensure that the interests of those with decision-making authority are aligned with the broader policy goals of a SIB transaction.

A. *Role and Decision-Making Authorities of Governance and Oversight Committees*

The pay for success contracts used in SIBs taking place in the United States typically specify governance or oversight structures for observing and managing progress and allowing parties to course correct or, if necessary, to terminate the transaction.⁸² These governance and oversight structures can play an important role throughout the duration of a SIB transaction. For example, in the early stages of a SIB transaction, adjustments to and renegotiation of performance indicators and timetables may be required, particularly if it takes longer than expected to start the delivery of social services to the requisite number of targeted beneficiaries. Thereafter, the governance and oversight structures can help assure personnel and programmatic continuity within stakeholders should there be personnel changes, which given the long duration of many SIB transactions is highly likely. More importantly, these structures also can help contracting parties manage and respond to those unexpected eventualities that may threaten the success of a SIB program. Then, at the end of a SIB's term—whether scheduled or unscheduled—these contractual governance and oversight structures can provide a process for helping stakeholders make future programmatic and policy decisions about how to wind-down or renew contracted social services for the targeted beneficiaries.

Most of the SIBs contracted in the United States during 2012 through 2017 use a dual oversight structure that includes two separate

⁸¹ Building contracts that promote the scaling of impact bring unique challenges. The traditional theory of change—how a program is expected to achieve impact at a given level of scale—expresses impact as a relatively static construct, often with graduated levels of activities, outputs, and outcomes to demonstrate a linear process of change that an innovation will travel to arrive at its eventual impact. In contrast, a scaling theory of change recognizes that scaling innovation is more dynamic. This scaling theory of change explains how scaling is likely to change the way a program achieves impact as it scales—sometimes for the good and sometimes not. Therefore, it is important to consider the trade-offs of scaling social interventions. See generally John Gargani & Robert McLean, *Scaling Science*, STAN. SOC. INNOVATION REV., Fall 2017, https://ssir.org/articles/entry/scaling_science.

⁸² See *Pay for Success*, *supra* note 19, at 14, 20.

committees, one tasked with providing *operational* oversight⁸³ and the other with *executive* oversight.⁸⁴ The operating committee focuses on monitoring the delivery of social services and usually has limited decision-making authority. It can, however, make recommendations to the executive or steering committee. In comparison, the executive or steering committee has greater decision-making authority and, among other things, may shorten or extend the duration of the project and replace parties (such as the independent evaluators, social service providers, project managers). Project managers or intermediaries often play the lead role in organizing and convening these governance committees. They also ensure that data management systems have been created to track and generate regular reports on program outputs and indicators for these committees.⁸⁵

B. *Composition of Governance and Oversight Committees*

At first glance, the composition of operating and executive or steering committees may look quite similar across SIBs with respect to the mix of represented stakeholders. Typically these committees include representatives of the contracting government authority, service providers, and, if present in the transaction, the project manager or intermediary.⁸⁶ Sometimes these committees also include evaluators and technical assistance providers.⁸⁷

Upon closer examination, however, there can be meaningful differences across the composition of these committees that reflect their varying decision-making authorities. It is likely, therefore, that the executive or steering committee, with its decision-making powers about strategic issues, may be populated with high-level leadership; and government payors may be represented by political appointees. In contrast, composition of the operating committee, which generally focuses on the manage-

⁸³ Operational oversight role is handled by the operating committee, which focuses on regular monitoring of the project's progress. This can include reviewing and troubleshooting operational components of the project, as well as identifying and implementing necessary course corrections. *Id.* at 20.

⁸⁴ Executive oversight is typically handled by the executive or steering committee, which monitors project progress through reports made by the project manager and/or operating committee. The executive or steering committee often has decision-making authority over the entire pay for success project, including, for example, determining any changes in who fills the project manager and/or service provider roles. This committee also typically determines whether any early termination events or rights are to be exercised. *Id.*

⁸⁵ *Id.* Monitoring outputs, as well as measuring outcomes, is important during the life of a SIB. These outputs can include the number of referrals made, the number of participants enrolled in the program, the days of services provided, etc. It should be noted, however, that "[t]hese data points are more similar to the outputs tracked in a traditional government contract, and not necessarily indicative of project success or impact."

⁸⁶ *Id.* at 21.

⁸⁷ *Id.*

ment and reporting requirements of the SIB's operations, typically will include representatives of the service providers and staff of those government agencies that are most closely aligned with serving the project's target population or are the source of outcome payments.⁸⁸ Also, not all members of these committees will have an equal voice on every matter to come before the committees. For example, committee members are likely to be excluded from decisions about matters where they may have an actual or perceived conflict of interest. Hence, a social service provider likely cannot vote on whether it is to be relieved of its responsibilities under a SIB.

C. *Protecting SIB Investors' Interests Inside Contractual Governance and Oversight Committees*

One place where there are divergences across the composition of governance and oversight committees included in pay for success contracts is the extent to which these committees include investors' voices. Most of the early SIBs launched in the United States do *not* give investors direct decision-making power within the SIB governance and oversight structure,⁸⁹ although the project manager or intermediary may take on this role on behalf of the investors.⁹⁰ Instead, in many of these early SIBs, investors typically are only allowed access to meetings of the oversight committee but only as observers or "non-voting" members. And, in some of the very earliest SIBs, even this observer status could be challenged or tightly circumscribed.⁹¹

Why haven't SIB investors demanded a bigger voice in the contractual governance and oversight structures found in U.S. SIBs? There is no

⁸⁸ *Id.*

⁸⁹ *Id.* In contrast, in the United Kingdom, many U.K. SIBs include investors within their governance structures, and limit the role of outcome payors in governance structures to that of observer. E-mail with Louise Savell, Dir., Social Finance, to author (June 10, 2019, 10:59 am) (on file with author).

⁹⁰ It should be noted, however, that some SIBs do not include an intermediary that can or even should play this investor representation role. For example, in the Utah High Quality Preschool Program, the transaction coordinator/project manager is United Way of Salt Lake, which is also a payor. In the Massachusetts Chronic Homelessness Pay for Success Initiative, the Massachusetts Housing and Shelter Alliance is the lead service provider and is a transaction coordinator, and its wholly-owned subsidiary is the project manager. *See Pay for Success*, *supra* note 19, at 8.

⁹¹ For example, in the Cuyahoga SIB of 2014, funders can ask to attend meetings of the Operating Committee as observers. This observer right, however, can be withdrawn if any members of the Operating Committee object for any reason or no reason to the funders' attendance. *See* Section 5.01(d) of Cuyahoga SIB. Similarly, funders' right to attend Governance Committee meetings as observers requires the consent of all the members, unless there is an event of default under their funding agreements (such as a payment failure by the borrower, a lender failure to disburse, or a termination event is triggered under the pay for success contract). In that case, funders may attend the Governance Committee as observers. *See* Section 5.02(b) of Cuyahoga SIB.

obvious single answer. Indeed, it is likely that a combination of factors may be dictating SIB investor behavior in this regard. The following discussion examines several possible explanations for the limited role played by SIB investors to date in the contractual governance and oversight committees of pay for success contracts. It then examines the implications of this limited investor role.

SIB investors are by no means a homogeneous group. In the United States, some of the most common SIB investors have included commercial banks, corporations, foundations (family, corporate, and institutional), high net worth individuals, and nonprofit organizations.⁹² Thus, they bring a very wide range of motivations and resources to these transactions.⁹³

One might have expected that SIB investors that have a deep commitment to a particular social issue and relevant expertise to bring to bear on that issue as it is being addressed by the SIB would want to exercise governance or oversight rights in a pay for success contract. But the numbers do not bear this out. In the pay for success contracts used in the United States from 2012 through 2017, socially-oriented investors appear no more likely than more commercially-oriented investors to invest in SIB deals where investors have a vote in the governance or oversight structure.⁹⁴

Another possible explanation is that investors in SIB transactions have not yet had sufficient experience in these deals to inform them of the value of participating in a governance or oversight committee. This lack of experience crosses two dimensions—within a single SIB and across multiple SIBs. Due to the relatively recent launches of SIB transactions in the United States, many SIB investors have not yet experienced (or are just now experiencing) the full life cycle of a SIB. So they have not yet had firsthand experiences in observing the roles that the governance and oversight committees play in that life cycle.

Compounding this lack of experience in any one deal is the fact that only a handful of investors have invested in more than one SIB transaction in the United States.⁹⁵ Very few SIB investors in the United States have experience across SIBs. More specifically, out of 18 SIB transac-

⁹² See *Pay for Success*, *supra* note 19, at 14. See also Del Giudice & Migliavacca, *supra* note 42, at 52 (participation of institutional investors in SIBs is marginal to date).

⁹³ See ALBERTSON ET AL., *supra* note 12, at 26 (describing differences across the “do good” motivations of SIB investors such as businesses engaging in corporate social responsibility activities or banks seeking to meet Community Reinvestment Act obligations in United States).

⁹⁴ An exception to this can be found in the Oklahoma Women in Recovery Project (2017) where the George Kaiser Family Foundation is the only investor (\$10 million). It has included a staff member on the Executive Committee.

⁹⁵ See Social Finance Impact Bond Database, *supra* note 3.

tions taking place in the United States from 2012 through 2017 which were reviewed by this author and for which investor data is public, 34 investors have been engaged as senior and/or subordinated investors/lenders.⁹⁶ Of those 34 investors, only 12 have invested in multiple SIBs in the United States.

More puzzling, however, is the fact that there is no observable trend of these 12 repeat investors improving their voting rights from early SIB transactions to more recent SIB transactions, with one notable exception. This suggests that even more experienced SIB investors have not yet seen reason to secure greater voting rights within these committees. Or, perhaps, they have not seen a reason that is compelling enough to outweigh concerns about the perceived costs, liabilities, or reputational risks of undertaking a proactive governance or oversight role.⁹⁷

The notable exception to this trend of limited investor involvement is a SIB investor that has invested in multiple U.S. SIBs, and at times has demanded that funders be given a voting role within the governance and oversight structure.⁹⁸ As a result, in the Denver and two Salt Lake County SIBs that were launched in 2016, investors play a more significant role in the governance and oversight structure.⁹⁹ Investors not only have observer rights to attend Operating Committee meetings,¹⁰⁰ but

⁹⁶ Another 14 organizations have provided grant funding—either recoverable grants or non-recoverable grants.

⁹⁷ Some commercial funders may be shying away from funding controversial social problems more generally. For example, in response to protests over Trump Administration immigration policies, JPMorgan Chase & Co. decided to stop financing private operators of prisons and detention centers. See generally David Henry and Imani Moise, *JPMorgan Backs Away from Private Prison Finance*, U.S. NEWS AND WORLD REPORT (Mar. 5, 2019), <https://money.usnews.com/investing/news/articles/2019-03-05/jpmorgan-backs-away-from-private-prison-finance>); but see WELLS FARGO, *Business Standards Report: Learning from the Past, Transforming for the Future* (Jan. 30, 2019), <https://www08.wellsfargomedia.com/assets/pdf/about/corporate/business-standards-report.pdf>.

⁹⁸ This investor is the Northern Trust Company. Northern Trust has only observer rights in the Chicago Child-Parent Center Pay for Success Initiative (2014), where it accounted for \$5.33 million of the \$12.66 million of senior debt raised (Goldman Sachs accounted for the remaining \$7.33 million). See *Pay for Success*, *supra* note 19, at 25. In the Denver SIB (2016), Northern Trust required a voting seat for itself and other investors. In the two Salt Lake City SIBs (2017), because there are multiple investors in those SIB transactions, the investors are represented by one voting member on the Executive Committee who votes on behalf of all investors.

⁹⁹ The South Carolina SIB (Nurse Family Partnership) (2016) also includes the three largest investors on its Executive Committee.

¹⁰⁰ In these 2016 SIBs, each of the pay for success contracts address two SIB transactions aimed at homelessness and criminal justice improvements. In the Denver SIBs (2016), lenders have observer rights for all meetings of the Operating Committee. In the Salt Lake County SIBs (2016), anyone (including the public at large) can attend open meetings of the Operating Committee. Funders will be dismissed from attending closed meetings of the Operating Committee only if necessary to preserve attorney/client privilege. See Section 5.01 (d) of Salt Lake County SIBs.

they also have voting rights on the Executive Committees.¹⁰¹ Other investors in these particular SIB deals have effectively gained a free-ride by benefiting from their fellow investor's insistence on obtaining voting rights for all. On the other hand, consistent with the repeat investor behavior described above, even after having received voting rights, these same SIB investors have not demanded voting rights in subsequent SIB deals to which they are party. This suggests that, while these SIB investors were willing to accept voting rights so as to not be in a disadvantaged position vis-à-vis other investors in their SIB transactions, they are reluctant to push for such rights absent such investor parity considerations.

Another plausible explanation is that other parties to SIB transactions may want to limit the role of SIB investors in the contractual governance and oversight committees of pay for success contracts in order to retain as many residual decision-making rights for themselves as possible. More specifically, neither the government outcome payor nor the social service providers may want to share control and decision-making authority directly with SIB investors due to distrust about the financial motivations of SIB investors and the extent to which SIB investors would relegate the interests of target beneficiaries of the SIB transaction below the investors' own financial interests. Or these parties may worry about the lack of relevant expertise that SIB investors would bring to bear on operational or strategic decisions. Yet these are not the only reasons why other parties to a SIB might be unwilling to share decision-making authority with SIB investors.

From the government payor perspective, imposing limitations on the role SIB investors play in the governance of pay for success contracts also may be motivated by legitimate concerns about relegating decision-making authority to private actors over the provision of important social services. The government payor also could be motivated by the existence of legal constraints on or legal uncertainty about the extent to which its contracting authority can be delegated to private actors. Additionally, there may be data privacy concerns about the need to adequately protect the privacy of individuals in the SIB's targeted population.

Similarly, other parties to the SIB transaction also may want to limit the decision-making rights of SIB investors. Beyond broader concerns about serving the interests of the SIB's target population, this may be due to the self-interests of the other parties. For example, a nonprofit service provider¹⁰² may worry about the U.S. tax consequences of participating

¹⁰¹ See Denver SIB at Section 5.02, Salt Lake County SIBs at Section 5.02.

¹⁰² It should be noted that, although many of the service providers in U.S. SIBs are organized as nonprofit organizations, this is not always the case. For example, the Utah High Quality Preschool Program included service providers that included public organizations, nonprofit

in transactions that are under the control of and possibly enriching those SIB investors that are organized as for-profit entities.¹⁰³ Or, the other parties may worry about reputational and political issues that could arise if SIB investors are seen to be exercising undue or outsized influence over the operation and management of a SIB.

Yet another likely and perhaps the most compelling explanation for why SIB investors typically do not demand voting rights is that SIB investors have found other more effective and less costly or risky ways to protect and advance their interests in these SIB transactions *outside* of the governance and oversight committees. It is this last explanation that is explored further here.

D. Protecting SIB Investors' Interests Outside of Governance and Oversight Committees

Instead of seeking a larger voice in the governance and oversight committees of SIB transactions, it appears that most SIB investors in the United States are looking to deal structures and contractual provisions to protect their financial, social, and reputational interests.

1. Mitigating Risks through Deal Structures

SIB investors in the United States have employed a variety of structuring strategies to mitigate the risks posed by these transactions. Some of these strategies are taking place *outside* of the SIB transaction itself. For example, to mitigate operational and execution risks, some SIBs in the United States have conducted pilot programs that allow parties to test and improve systems for enrollment of beneficiaries, data tracking, and service delivery, to name a few, before formally launching the SIB and seeking investors' capital.¹⁰⁴ To mitigate appropriations risk, some SIBs have included sinking funds, escrow accounts, and other forms of set-

organizations, private organizations, and charter school. Similarly, the South Carolina Nurse-Family Partnership included service providers that were quasi-public entities, nonprofit organizations, and public organizations. See *Pay for Success*, *supra* note 19, at 19.

¹⁰³ See generally Sean Delany and Jeremy Steckel, *Balancing Public and Private Interests in Pay for Success Programs: Should We Care About the Private Benefit Doctrine?*, 14 NYU J. L. & Bus. 509 (2018) (examines how charitable entities in the U.S. must take care in transacting with profit-making entities in SIB transactions to avoid running afoul of the private benefit doctrine).

¹⁰⁴ See *Pay for Success*, *supra* note 19, at 18. Sometimes these pilots are funded by investors as part of the overall SIB transaction; other times they are funded with philanthropic contributions. Similarly, sometimes these pilots take place before the formal launch of the SIB; other times they are part of the SIB.

aside accounts to ensure that adequate funding has been provided to government outcome payors.¹⁰⁵

Other structuring strategies are taking place *within* the SIB transaction. For example, some SIB investors have tranching their funding to social service providers, often conditioning disbursements upon the achievement of certain milestones or performance indicators.¹⁰⁶ And in two of the earliest SIB deals, SIB investors have made use of credit enhancements in the form of third party guarantees.¹⁰⁷ Still, others have turned to their fellow SIB investors to mitigate risks by creating capital stacks that provide a range of priorities across SIB investors, with some investors taking subordinated positions to others.¹⁰⁸

These are not the only ways that risks can be mitigated through creative deal structures, but the above discussion highlights some of the common structures used to protect SIB investors' interests in the SIBs that have been launched in the United States.

2. Mitigating Risks through Contractual Protections

SIB investors also appear to be relying on a variety of contractual provisions to protect their interests. Many of these contractual protec-

¹⁰⁵ See, for example, Massachusetts Social Innovation Financing Trust Fund that is backed by the full faith and credit of the Commonwealth of Massachusetts. MASS. GEN. LAWS ch. 10, § 35VV (2012).

¹⁰⁶ See *supra* text accompanying notes 26 and 27 (describing how Goldman Sachs tranching its disbursements to the Rikers SIB and then determined to stop disbursing after receiving discouraging preliminary results).

¹⁰⁷ Only two of the earliest SIBs in the United States include a third party guarantee. In both cases, these were partial guarantees offered by philanthropic foundations to help de-risk the SIB transaction for its private sector investors. Bloomberg Philanthropies provided a \$7.2 million guarantee to Goldman Sachs for the Rikers SIB (launched in 2012). The Rockefeller Foundation provided a \$1.3 million guarantee to Bank of America Merrill Lynch for another New York SIB, which was focused on increasing employment opportunities and reducing recidivism rates of formerly incarcerated individuals (launched in 2013). Bank of America Merrill Lynch was acting on behalf of a group of dozens of investors, which included individuals, institutional foundations, and family foundations. The Rockefeller guarantee did not extend to all of the investors. For example, several of the large foundations, such as the Robin Hood Foundation, were not beneficiaries of this guarantee. See *Pay for Success*, *supra* note 19, at 25–26.

¹⁰⁸ This subordination can come in multiple forms—by form of instrument and by priority and timing of payment. For example, some funders are contributing grant capital—either nonrecoverable (see, for example, Massachusetts Juvenile Justice PFS Initiative (launched in 2014), which included \$6 million of nonrecoverable grants) or recoverable (see, for example, Santa Clara's Project Welcome Home SIB (launched in 2015), which included a recoverable grant of \$500,000 from Google.org). Other funders have taken a subordinated debt position relative to more senior lenders (see, for example, Utah's High Quality Preschool Program (launched in 2013), which included a subordinated lender—the J.B. and M.K. Pritzker Family Foundation—and a senior lender—Goldman Sachs). For more examples of how layered capital stacks have been used in U.S. SIBs, see *Pay for Success*, *supra* note 19, at 23–26.

tions are likely found in the SIB investors' funding agreements.¹⁰⁹ For example, investors may be able to shape social service providers' behavior through the covenants that investors are imposing on these providers either directly or, if the funding runs through an intermediary, indirectly, in their funding agreements. But for purposes of this discussion, I focus on the contractual provisions found in the more publicly-available pay for success contracts that undergird SIB transactions. Even though SIB investors are rarely parties to a pay for success contract, they still often benefit from the contractual provisions found in these pay for success contracts.

One key set of contractual provisions found in pay for success contracts that can be used to protect SIB investors' interests are the contract termination rights commonly found in pay for success contracts in the United States.¹¹⁰ These termination triggers function much like events of default in a loan agreement and, where appropriate, can even include cure periods. Some pay for success contracts give SIB investors the contractual right to trigger a termination of the pay for success contract before its scheduled end date under certain circumstances or, as is more often the case, investors' consent may be required before other parties to the pay for success contract can trigger a termination.¹¹¹

While termination rights will vary from SIB to SIB, they typically correspond, just as events of default in a loan agreement do, with the perceived key risks of the project. Accordingly, many pay for success contracts in the United States include some version of the following termination rights related to particular risks inherent in SIB transactions:

1. *Implementing/Operating Risk.*

- a. Termination Event: Enrollment shortfall. This refers to a failure to enroll a specified number of targeted beneficiaries in the project in accordance with the project's schedule.

¹⁰⁹ Some of the pay for success contracts housed in the Nonprofit Finance Fund's database include, as attachments or schedules, draft term sheets for the SIB investors' funding agreements. While a term sheet, let alone a draft term sheet, does not provide conclusive evidence of the provisions of the final agreements, they can provide a roadmap as to how issues are likely to be addressed in the resulting funding agreements.

¹¹⁰ See *Pay for Success*, *supra* note 19, at 20.

¹¹¹ See, e.g., Section 8.06 of Denver SIBs (2016) (early termination of the contract requires lender consent); Section 5.03 of Salt Lake SIBs (2016) (funder consent required to extent actions by Executive Committee could materially adversely affect rights of funders); Section 10.01 of Cuyahoga SIB (2014) (early termination generally requires both Governance Committee and lender consent). Whether the parties will actually use these termination rights is another story. Again, like events of default, these rights serve as background norms to channel and shape participants' expectations.

- c. Termination Event: Bankruptcy of the intermediary/project manager. This refers to a failure to replace the intermediary/project manager should bankruptcy proceedings be instigated for the intermediary/project manager.
 - d. Termination Event: Financing shortfall. This refers to a failure to reach the requisite amount of funding commitments from SIB investors, or such SIB investors failing to deliver funding in accordance with their commitments.
 - e. Termination Event: Key party replacement. This refers to a failure to replace a key party (such as the independent evaluator, intermediary/project manager, or service provider) in a timely fashion after that party is terminated or voluntarily quits the project.
4. *Regulatory or policy risk.*

Termination Event: Adverse policy/regulatory change. This could take the form of a policy change that prevents a service provider from delivering expected services to target beneficiaries or other regulatory changes that make the likelihood of continuing the SIB transaction impractical.¹¹⁴

Other contractual rights that some SIB investors enjoy in pay for success contracts taking place in the United States relate to amendment or modification provisions. For example, some pay for success contracts require funders' consent before key parties are replaced, such as the independent evaluator, project manager/intermediary or service providers.¹¹⁵ Others require the funders' consent before changes can be made to the pay for success contract that affect the amount or timing of outcome payments.¹¹⁶ At least one pay for success contract goes further and provides that funders can challenge the evaluation reports or conclusions of the independent evaluator if they can demonstrate that these evaluator's conclusions will materially change the amount of outcome payments to

¹¹⁴ The early termination of the Peterborough SIB is an example of how a change in governmental policies or regulations might cause the pay for success contract to terminate early. See Peterborough SIB Press Release, *supra* note 1, at 4.

¹¹⁵ See, e.g., Massachusetts SIB (2014).

¹¹⁶ See Chicago SIB (2014) Section 8.01; Santa Clara SIB (2015); Denver SIBs (2016) (if extending term of pay for success contract, need lender consent); Salt Lake County SIBs (2016) Section 12.16 (if there is a conflict between the pay for success contract and the funders' agreements, the funders' agreements prevail).

be made.¹¹⁷ Finally, some pay for success contracts also limit assignment rights and require funders' consent before the obligations and duties of the contracting parties can be assigned to others.¹¹⁸

VI. STANDARDIZING PAY FOR SUCCESS CONTRACTING

It is expensive to transact a SIB in the United States by almost any measure that counts—that is, financial and time. In the United States, for example, the average SIB deal can take two years to launch. The relatively high costs of transacting SIB deals as compared to their investment size¹¹⁹ have led to growing calls for the need to standardize or create template SIB documentation.

While the cost-benefit analysis of standardization as a means of reducing the cost of contracting is subject to debate,¹²⁰ is it even possible to standardize an incomplete contract? Experiences with the public-private partnership contracts used for infrastructure projects suggest it is possible – perhaps to a surprising degree.¹²¹ Thus, there are likely to be opportunities for at least some level of standardization across SIB documentation.

Before there is a rush to standardize pay for success contracts, however, at least three questions should be considered: when, how and where. First, *when* is the field ripe for standardization? As others have noted, “. . . standardization impedes the development of novel or innovative terms.”¹²² Are we ready to exchange innovation for standardization

¹¹⁷ See, e.g., Salt Lake County SIBs (2016) Section 6.08(d) (any funder, either service provider, county, project manager, or SPV may challenge the conclusion of independent evaluator in evaluation report that challenging party can demonstrate will reduce or increase success payments by more than \$25,000).

¹¹⁸ See, e.g., Chicago SIB (2014) Section 8.02.

¹¹⁹ In the first ten SIB transactions launched in the United States, the initial capital raised ranged from \$3.5 million to \$21.6 million. While there has been a great variation in the amount of capital raised for these U.S. SIBs, a consensus is emerging that the minimum threshold is between \$5 million and \$10 million given relatively high transaction costs and interest of investors in financing larger investment opportunities. See *Pay for Success*, *supra* note 19, at 3, 23.

¹²⁰ “The gains from standardization are purchased at considerable cost.” Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW* 149–92 (Jody S. Kraus & Steven D. Walt eds., Cambridge University Press) (2000). Not examined fully here, but worthy of further analysis, is the question of how enforcement of SIB documentation should be regulated by the state. Scott provides a framework for considering the role of the state in the legal enforcement of incomplete contracts more generally.

¹²¹ See Van Den Hurk & Verhoest, *supra* note 78, at 288–91. There is another important reason for standardization of public-private partnerships contracts, which is to facilitate learning across the sector. Standardization can help spread best practices and promote common understandings of the key risks found in contracting. It also can help new actors to avoid repeating the mistakes of those who conducted earlier transactions. *Id.*

¹²² Scott, *supra* note 120, at 158–59.

in pay for success contracts? Put differently, do we have sufficient experience in transacting SIBs to start standardizing documentation or do we need more time to continue to experiment and learn from the early deals?

Second, *how* should standardization occur? That is, what and who should drive (and, perhaps, invest in) the push for standardized documentation—government, market participants, or other stakeholders? Does it matter if the party taking the lead in creating standardized contract provisions is organized as a for-profit or nonprofit entity?¹²³ Drivers of standardization could be top-down mandated by a government contracting authority.¹²⁴ Drivers also could be bottom-up—pushed more organically by market forces and shared practices as SIB transactions engage more repeat players and advisors.¹²⁵ Or, as appears to be happening in the United States, it could be a mixture of the two, particularly as it is taking place in jurisdictions where governments enact framework legislation that provides general guidance as to what terms are expected to be included in the contractual arrangements of a SIB.

Finally, *where* is standardization likely to be most effective at this relatively early stage in the development of SIBs? Is this standardization to take place across jurisdictions or just within particular jurisdictions? Similarly, which parts of a pay success contract are most amenable to standardization? It is this latter question that I turn to now.

Pay for success contracts are not only incomplete but these contracts also can be complex. Their complexity can be measured on several dimensions: 1) expected number of relevant contingencies specified in the contract, 2) magnitude of variances under different contingencies, and 3) extent to which the contract terms are difficult to understand.¹²⁶

¹²³ See generally Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075 (2006) (examines the extent to which it makes a difference if the creator of boilerplate contractual terms is a nonprofit organization rather than a for-profit corporation).

¹²⁴ For example, New South Wales has promoted template documentation to try to stimulate more common contracting approaches to SIBs. See NEW SOUTH WALES OFFICE OF SOCIAL IMPACT INVESTMENT, FINANCIAL MODEL TEMPLATE, <https://www.osii.nsw.gov.au/tools-and-resources/financial-modelling-template/> (2018). Similarly, the United Kingdom has supported the creation and dissemination of a template contract for use in U.K. SIBs and other payment by results contracts. See Social Impact Bond template contract, <https://www.gov.uk/guidance/social-impact-bonds> (2012); Guidance on Template Contract for Social Impact Bonds and Payment by Results, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/645183/20170223_FULL_GUIDANCE_SIB_TEMPLATE.pdf (2012).

¹²⁵ As noted previously, several of the project managers/intermediaries supporting U.S. SIBs have worked on multiple SIB transactions and, therefore, carry lessons and contracting approaches from one deal to another. Notable examples are Third Sector Capital and Social Finance. Similarly, as lawyers build practices around pay for success contracting, they too help to transfer knowledge from deal to deal about how to document SIB transactions.

¹²⁶ Eggleston et al., *supra* note 55, at 97 (characterizing difficult to understand contract terms as the heft of the “cognitive load”).

By this measure, most pay for success contracts hit the trifecta, scoring high on all three of these dimensions of complexity.

As a theoretical matter, pay for success contracts can fall into one of four categories based on the complete/incomplete and simple/complex continuums depicted below.

	Incomplete	Complete
Simple	Simple Incomplete	Simple Complete
Complex	Complex Incomplete	Complex Complete

While the most optimal contract would be simple and functionally complete (upper right corner of the above chart), many of the pay for success contracts undergirding U.S. SIBs fall into the worst of both worlds—complex and incomplete (lower left corner of the above chart).

But must this pattern of SIB contracting complex and incomplete agreements continue? I argue that, although the social problems that SIBs attempt to prevent are complex, this does not mean that the contractual arrangements that support a SIB need to be similarly complex. Indeed, there may be opportunities to use standardized approaches to reduce contract complexity in ways that reflect the incompleteness of pay for success contracts. All of this suggests that a particularly apt place for standardization to start in pay for success contracting, even in these early days of experimentation and innovation, is with respect to the contractual governance and oversight provisions.

As the above discussion of the current state of contractual governance taking place in U.S. SIBs indicates, governance and oversight committees are typically found in the pay for success contracts being used in the United States. Yet, many of these contracts have not effectively mobilized the investor voice within these committees, and have expressly prevented investors in some cases from directly participating in joint decision-making with other parties to SIBs.

While there are many possible reasons for this exclusion, the implications are profound. Namely, SIB investors that have limited decision-making authority are unlikely to act as an effective brake on quality-shading behaviors of social service providers. And, as occurred in the Rikers SIB, investors may be more likely to cut their losses and move to terminate a SIB that is encountering challenges, rather than work on redesigning or adjusting the SIB structure and goals. Accordingly, taking steps toward sharing learnings about the effectiveness of current governance and oversight structures in aligning parties' interests could inform the standardization process.

Standardization of the governance and oversight mechanisms of pay for success contracts could be advanced in at least two ways. First, there could be a greater focus on establishing guidelines and best practices, rather than standard contract terms, regarding the roles, functions, composition, and decision-making processes of the contractual governance and oversight mechanisms used in pay for success contracting.¹²⁷ This approach should provide useful direction without stymieing the innovation and experimentation necessary to this field's advancement.

Second, there could be a continued effort to foster a culture of transparency around the pay for success contracts that are being developed. The standardization of pay for success contracts that has occurred to date in the United States, as noted above, has benefitted from the existence of a contract database hosted by the Nonprofit Finance Fund, which is accessible and free of charge to the public.¹²⁸ It also has benefited from parties' willingness to share learnings with each other, including the growing cadre of lawyers with knowledge about the documentation used across a range of SIBs and its effectiveness. Growing this database and culture of transparency, which allows a diverse group of dealmakers, lawyers, policymakers, and even scholars like myself to engage in a form of collective enterprise¹²⁹ that creates, compares, and analyzes contractual provisions across SIB transactions, may prove to be one of the most impactful tools for advancing learning in ways that build this field.

CONCLUSION

This Article sets out an ambitious agenda. First, it described the state of pay for success contracting for SIBs in the United States from 2012 to 2017—where it started and how it has evolved. Then it described where pay for success contracting for SIBs might benefit from standardization.

Pay for success contracts, it turns out, are distinctive in that they are both incomplete and complex, much like other long-term, public-private partnership contracts. As Nobel Laureate Oliver Hart's theory of incomplete contracting might have predicted, upon confronting the challenge of

¹²⁷ For example, the roles of the contractual governance and oversight committees in pay for success could be standardized. This would allow for a clear understanding of the extent to which decision-making authority is delegated across and within the two committees. The composition and voting rights of members in these committees could be standardized. The processes for appointing committee members that represent multiple actors (such as a SIB investor representative or SIB beneficiary representative) also could be standardized. Other governance topics that could benefit from standardization would include the processes for excluding committee members from voting where there are real or perceived conflicts of interest, and for safeguarding the data privacy of SIB program beneficiaries.

¹²⁸ See *supra* note 46.

¹²⁹ See Davis, *supra* note 123, at 1094 (recognizes value of having diverse members engaged in assisting the drafting of boilerplate contractual terms).

contracting in an uncertain and changing world, parties to pay for success contracts are likely to rely on contractual governance and oversight provisions rather than undertake the expense and time necessary to deal expressly with all possible contingencies that could frustrate the goals of their SIBs. Yet, these contractual governance and oversight mechanisms generally have not given voting rights to SIB investors, thereby leaving out an important brake on quality-shading behaviors of social service providers.¹³⁰ This exclusion may be limiting the effectiveness of these governance and oversight mechanisms—particularly given the possibility that some service providers in SIBs may pursue cost reductions at the expense of delivering quality.

As this Article attempted to catalogue, there are multiple explanations for why investors in SIBs may have not taken a more proactive role or demanded a bigger voice in the governance and oversight committees established by pay for success contracts. Chief among them appears to be investors' perception that there are easier, less costly and possibly less risky ways to protect their interests—such as through deal structures and other contractual provisions found in pay for success contracts and funding agreements. Indeed, it seems likely that SIB investors are influencing the behavior of social service providers through the covenants imposed in their funding documents. Since those agreements are not typically made public, however, it is difficult to describe with any accuracy (although not hard to imagine) the ways that investors may be working behind the scenes to secure successful outcomes and mitigate risks, and thus ensuring a financial return on their investments.

If the field of pay for success contracting is to grow, however, there will need to be a greater convergence of views as to the role that investors should play in SIB transactions. This suggests that there should be more transparency around the funding agreements used in SIBs. It would also be useful to take steps toward sharing lessons about the effectiveness of current governance and oversight structures found in pay for success contracts. Then, there could be an opportunity to standardize, through codifying best practices, the roles, functions, composition, and decision-making processes found in the governance and oversight mechanisms of the pay for success contracts that undergird SIBs.

¹³⁰ It should be noted, however, that a SIB investor who takes its observer rights seriously and, therefore, is vocal about its views on how the SIB is progressing may be able to shape social service provider behaviors without ever casting a vote.