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PAY FOR PERFORMANCE:
UNDERSTANDING SOCIAL IMPACT BONDS

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I. Introduction

Evidence-based preventative social services programs promise increasingly effective solutions to numerous social concerns including homelessness, recidivism among criminal offenders, workforce development and health care. Unfortunately, implementing such programs remains a continuing challenge for both nonprofit organizations and governmental entities. Nonprofit organizations typically have limited resources and need to invest significant time in fundraising to scale their programs effectively. Further, without adequate funding or support they may be unable to develop and implement data-driven evaluation tools to measure and determine if their programs are able to achieve the desired results. In the meantime, cash-strapped governments which may, in the long-term, save money through preventative social service interventions are often unable to assume the up-front financial risk of untested programs.

Social Impact Bonds (“SIBs”) are an innovative approach to financing programs dedicated to achieving specific social outcomes by aligning the incentives of the nonprofit sector, the government and private investors. Although relatively new – the first SIB was launched in the UK in 2010 – interest in this “pay for success” model of social investing continues to grow both domestically and internationally.

According to the model, which is structured to improve outcomes and reduce – or more effectively target – government spending, private investors pay for preventive (and proven) social service interventions with the expectation that if the services deliver their intended results, governments will reimburse the investors with a return on their investment. Investors will thus have the opportunity to make a socially and financially beneficial investment, and the government will be able to encourage and ultimately support successful, large-impact preventative social programs in a cost-efficient manner.

Although still in their early stage, SIBs have the potential to allow nonprofits and government agencies to tap into private funds to both improve services to disadvantaged populations and to test new approaches to curing social ills.
II. What is a SIB?

SIBs, also known as “Pay for Success” arrangements, are public-private partnership financing vehicles for much needed social service programs. They encourage up-front private investment in programs that achieve discrete social outcomes with the promise that, if the program is successful, the government will repay the private investor with a return on the investment. In this way, SIBs shift and apportion the risk involved in implementing and scaling promising preemptive social service interventions. The SIB is not, strictly speaking, a bond, but instead a complex set of contracts between multiple parties including a government agency, nonprofit service providers, investors, an external intermediary which manages the program and independent third-party evaluators which confirm whether target outcomes have been achieved according to negotiated terms. In a SIB financing, the initial financial risk of new programs is shifted from the government to private investors and thereby imposes additional “market” rigor on the transaction. The investors are only repaid and earn a return on their investment if the program turns out to be a success.

The structure of the SIB places an intermediary organization at the center of a series of transactions. The intermediary raises capital from the SIB investors which allows nonprofit service providers, under the supervision of the intermediary, to implement their program. The intermediary also communicates with the independent third-party evaluators and the government agency to monitor the effectiveness of the program. If the program reaches its negotiated goals, the intermediary funnels government agency payments back to the investors.

In addition to the intermediary, SIBs involve a number of other parties which play key functions throughout the transaction. These functions are frequently played by more than one party:

- **Investors** provide the up-front capital needed to bring the intervention to scale;

- **Charitable funders** invest capital in the transaction, provide a guarantee for investors or provide grant funding in connection with the project;

- **Technical assistance providers** advise government agencies on the benefits of the SIB model and consult on program design, cost-benefit analysis, and evaluation design;
• A **placement agent** liaises among potential investors to secure capital commitments to the transaction and represents the investors’ interests during the structuring phase;

• The **payor** (usually a **government agency**) provides outcomes-based payments and advocates for public and taxpayer interests throughout the project;

• **Nonprofit service providers** deliver intervention services to the target population in order to achieve agreed-upon outcomes;

• An **evaluator** designs the evaluation methodology used to measure the success of the provided services and measures whether such outcomes have been achieved;

• **Legal counsel** provides advice during the negotiation, structuring, and documentation process; and

• The **validator** provides independent substantiation that the outcomes have been measured according to the agreed-upon evaluation methodology

To illustrate how these parties interact, attached to this outline are a fact sheet, project summary, and the recitals from the intermediary contract for the New York State Recidivism Project described below.

### III. SIB Examples

Recent SIB financings include:

**UK Employment and Recidivism.** The first SIB was launched in Fall 2010 to reduce recidivism among men released from Peterborough Prison in the United Kingdom. Under the terms of the financing, nonprofit service providers will deliver intensive support to 3,000 short-term prisoners over a six-year period, both inside the prison and after release, to help them resettle into the community. According to results released by Social Finance Limited in 2014, the project reduced reoffending by 8.4 percent when compared to a control group. Although a 10 percent reduction would
have triggered immediate repayment to investors, the results indicated that investors are on track to receive returns in 2016.¹

**Recidivism at Rikers Island.** In August 2012, the City of New York agreed to SIB financing to reduce recidivism among 16-18 year olds incarcerated on Rikers Island through the use of cognitive behavioral therapy for young offenders. The loan will be repaid based on realized and projected cost savings by the City of New York due to decreases in re-incarceration.

**New York State Recidivism Project.** In 2013, New York State announced the first state-led SIB project to launch in the United States. The five-and-a-half-year project will expand comprehensive employment intervention to serve 2,000 formerly incarcerated individuals in New York City and Rochester by providing life-skills training, transitional jobs, job placement services, and post-placement support. For investors to be repaid, the project must reduce recidivism by at least 8 percent and/or increase employment by at least 5 percentage points. The total performance-based payment is capped at approximately $11 million for Phase I and $10.5 million for Phase II of the project.

**Salt Lake City High Quality Preschool Program.** In 2013, Salt Lake City County, Utah agreed to SIB financing for the expansion of the Utah High Quality Preschool Program, which provides early education services for up to 3,500 students. The loan will be repaid based on the number of students flagged as likely to use special education and remedial services who then subsequently do not use such services every year from kindergarten through sixth grade.

**Massachusetts Juvenile Employment and Recidivism.** In 2014, the Commonwealth of Massachusetts agreed to SIB financing to expand a high-impact intervention program to increased numbers of at-risk young men in Massachusetts who are in the probation system or exiting the juvenile justice system. The program seeks to reduce recidivism and increase employment through intensive street outreach and targeted life-skills, education and employment programming. Massachusetts will make up to $27 million in success payments for this seven-year project if services are proven to produce positive outcomes, including decreases in incarceration, increases in job readiness and increases in employment attained by the young men participating in the program.

Chicago Child Parent Center Preschool Model. In 2014, Chicago agreed to SIB financing to expand the Child Parent Center preschool model used in low-income and high-risk communities in Chicago. The financing allows this preschool education model, which has a proven track record of better preparing children for kindergarten and decreasing the use of special education, to serve an additional 2,650 Chicago public school students over the next four years and will be repaid based upon evidence of (i) reduced need for special education services; (ii) improved kindergarten readiness; and (iii) grade level reading in the third grade.

Federal Interest. Interest in SIB financing is growing at the federal level. Beginning in fiscal year 2012, the Obama Administration has requested at least $100 million to support pay for success models in domestic discretionary spending programs to reduce recidivism, provide workforce training, and combat homelessness. In the 2014 and 2015 budget proposals, the Administration also requested a $300 million fund, administered by the Treasury Department, to incentivize state and local governments to develop SIBs.

On March 4, 2015, Representatives Todd Young (R-IN) and John Delaney (D-MD) introduced congressional legislation supporting broad federal support for social impact financing. The Social Impact Partnership Act (H.R. 1336) contemplates federal funding for social impact financing at the state and local levels relating to, among other things, unemployment, recidivism among individuals released from prison, moving children out of foster care, lowering rates of disease among low-income families, improving education for special-needs and low-income children, and other problems which can be fixed through evidence-based social programs. Under the act, a newly formed Federal Interagency Council on Social Impact Partnership would (i) issue requests for proposals from state and local governments for social impact programs, (ii) support feasibility studies for such projects, and (iii) pay up to $300 million to support state and local governments for successful projects over a ten-year period.

IV. The Role of Charitable Funders

Private foundations and other charitable organizations can support SIB transactions in a number of ways. They have been instrumental in fostering and promoting an awareness of SIBs, articulating a rationale for their utilization, studying their application, and imagining how SIBs can effectively address intractable social problems in concert with governmental and private sector stakeholders. Indeed, grant funding has supported studies, demonstration projects, and sector building initiatives aimed at developing a robust body of knowledge around SIBs, which are forming the
basis for a greater understanding and utilization of SIBs and intelligent policymaking in support of the field. Charitable funders have also helped build the capacity of the nonprofit service providers that are carrying out the intervention programs on which the success of any SIB project depends. Finally, it is contemplated that both the structuring intermediary and the nonprofit service providers are, or will be, charitable organizations. Grant funding has supported the SIB intermediaries and service providers by building capacity, helping them develop effective programs to structure, manage, and evaluate SIB transactions, supporting and helping to scale existing programs and enabling the development of measurement tools for assessing outcomes.

Of equal importance is the ability of charitable organizations, primarily private foundations, to serve as a source of investment or “first-loss” capital for specific SIB transactions. For example, private foundations can invest in a SIB transaction, induce private sector investors to invest by providing guarantees or funding first-loss reserves, or by providing grant capital to help expand the program or fund a portion of the returns (thereby alleviating the governmental funding burden). Because financial returns on a SIB are contingent on future social outcomes – rather than financial performance – investors in SIBs typically have a high tolerance for risk and a desire, first and foremost, to support the specific social or charitable outcomes of the SIB. In this way, SIBs are emerging as a prime program-related investment (“PRI”) vehicle for private foundations.

V. Structuring an Investment in a SIB as a Program-Related Investment

A private foundation that makes any investments that would financially jeopardize the carrying out of its exempt purposes becomes subject to certain excise taxes under Section 4944 of the Internal Revenue Code (the “Code”). The Code restricts jeopardizing investments to ensure that foundation managers do not make unnecessarily risky investments which will ultimately hinder the foundation from fulfilling its exempt purpose. Although the Code does not offer a simple definition of jeopardizing investments, in general an investment will be considered jeopardizing if it shows a lack of reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation. Ultimately, a private foundation investor must engage in a facts and circumstances analysis to determine whether an investment will trigger the provisions of Section 4944, based upon the foundation’s investment portfolio and risk tolerance.

An initial tax of 10% of the amount of the investment is levied on the foundation for any violation of Section 4944. In addition, a 5% tax (up to a maximum of $10,000)
may be imposed on the foundation managers. A second-level tax of 25% may be imposed on the foundation (5% for the foundation managers, up to a maximum of $25,000) if the jeopardy situation is not corrected within a certain period.

PRIs are an exception to the jeopardizing investment rules. A PRI must significantly further the foundation’s exempt activities, such that the investment would not have been made but for its relationship to those activities. While a PRI may incidentally (or ultimately) produce significant income or capital appreciation, the terms of the investment are generally less favorable than terms available for similar investments in the market.

In order to qualify as a PRI an investment must fulfill three tests:

(a) the primary purpose of the investment must be to accomplish one or more of the foundation’s exempt purposes;

(b) production of income or appreciation of property must not be a significant purpose of the investment, although incidental profit is acceptable; and

(c) influencing legislation or taking part in political campaigns on behalf of candidates must not be a purpose of the investment.

PRIs provide numerous advantages to private foundations. In addition to counting toward a private foundation’s 5% minimum payout requirement, they are excluded from the foundation asset base used to calculate the minimum payout amount, and are excluded from the excess business holdings rule, which generally restricts a private foundation from holding more than a 20% interest in a business enterprise. In addition, PRIs can be directed not only to 501(c)(3) charitable organizations, but to for-profit entities engaged in charitable activities.

The focus of SIBs on identifying and addressing difficult social problems, the strong governmental interest, funding commitment and role in enabling SIB transactions (often through specific legislation), and the significant presence and role of public charity intermediaries and social service providers, will generally ensure that SIBs satisfy (or at least provide a strong basis for satisfying) the primary charitable purpose requirement of a PRI.

Moreover, the heightened financial uncertainty and risk associated with these transactions, the modest potential for financial return in light of such risk, as well as the mission-first aspect of a private foundation’s involvement, will provide most
foundations with the basis for concluding that a SIB transaction satisfies the second prong of the PRI analysis relating to the foundation’s lack of a significant profit-motive purpose.

Nevertheless, it is still important for a PRI investor in a SIB transaction to document these factors as part of its internal file for the transaction (or in the form of an opinion of counsel in connection therewith).

VI. Lifecycle of the Deal

As described above, a successful SIB transaction involves numerous parties from inception to final payment. The intermediary generally plays a central role, negotiating between the investors, nonprofit service providers, and government agencies. Generally, a SIB transaction will include the following components:

1. Finding the Project: The intermediary or government agency will identify social needs that would benefit from nonprofit intervention. Following due diligence, appropriate projects will be identified for which (i) data can be readily collected and their efficacy measured; (ii) an effective solution or program is available and can be scaled to impact; (iii) government funding is not readily available; and (iv) early intervention will save government funds in the long-term.

2. Securing the Government Contract: Because government funding in a SIB is contingent on future outcomes, the intermediary needs to ensure that the government agency can secure long-term legislative authorization or a dedicated funding source to repay the investors upon successful completion of the project. In addition, the intermediary will need to negotiate the appropriate metrics to determine success.

3. Structuring the Investment: With the government commitment in place, the intermediary will perform financial modeling and present a deal structure to various investors. Specific points of negotiation will include the investment structure, pricing, payment schedule, investment term, underwriting terms, termination conditions, representations and warranties, and evaluation metrics.

4. Raising Capital and Managing the Project: After negotiating the relevant documentation and raising the investment capital, the intermediary will fund the program. Throughout the term of the SIB, the intermediary will call capital from investors, disburse payment to nonprofit service providers and oversee the project through final investor repayment.
VII. Documentation and Negotiation

The intermediary rests at the center of all negotiations in a SIB financing and is party to most of the relevant documentation. Below are the types of agreements that may be found in a SIB transaction:

1. “Ramp Up” Agreement among the government agency, intermediary, nonprofit service provider, evaluator, and any additional project managers defining the roles of the various parties in the planned SIB.

2. Intermediary Contract between the government agency and intermediary defining the relationships among the investors, intermediary, nonprofit service providers, government agency and evaluators; establishing the metrics by which program success will be measured; defining the capital needs of the program; and setting the terms of government repayment.

3. Grant Agreements or Lender/Investor Agreements between the investors and the intermediary, defining the terms of the investment, including any subordination and intercreditor agreements among the investors.

4. Validator Agreement between the intermediary and the validator measuring and reporting on the outcomes of the program.

5. Evaluator Agreement between the intermediary and the evaluator defining the role of the evaluator in measuring the effectiveness of the program.

6. Project Manager Agreement between the intermediary and any additional third-party project managers that may help manage the program.

7. Fiscal Services Agreement between and among the investors, intermediary and any third-party vendors who manage investor capital.