DRAFT

Mark Friedman

THE PROS AND MOSTLY CONS OF CONTINGENCY FEE CONTRACTING FOR REVENUE MAXIMIZATION PROJECTS

The Center for the Study of Social Policy
1250 Eye Street, NW, #503
Washington, DC

November 1, 1994

DRAFT

Mark Friedman
CSSP - 11/1/94

THE PROS AND MOSTLY CONS OF CONTINGENCY FEE CONTRACTING FOR STATE REVENUE MAXIMIZATION PROJECTS

Introduction

As market concepts gain currency in government circles, state officials are thinking about ways to harness the profit motive to energize government operations and make them more efficient. Some of these ideas are bearing fruit, as government agencies begin to think of themselves as customer service organizations with real customers, whose needs count. Other uses of market concepts have produced mixed results, such as the move toward privatizing government services.

One of the ideas which has generated increasing interest is the use of contingency fees for private providers of service to government. One of the subcategories of contingency fee contracting is the use of such contracts for state revenue maximization efforts. Revenue maximization efforts are generally designed to reduce general fund expenditures by increasing federal fund claims, or increasing collections of debts owed by third parties. There are some firms in the country which specialize in advising states on such matters and helping states implement revenue maximization programs notably in the areas where federal funding is still open-ended, such as Child Welfare, Title IV-E and Medicaid, Title XIX.

The purpose of this paper is to discuss when contingency fee contracting makes sense and, candidly, present the general case against state use of contingency fee contracts for revenue maximization efforts.

I write this with a relevant base of experience. For over six years I served as the chief financial officer of the Maryland Department of Human Resources with responsibilities for a budget exceeding $800 million and programs covering a wide range of areas from public welfare payments to child support collections to social service programs. During my tenure

with the Department I had direct experience with contingency fee contracts that worked well and with some that worked badly. I believe that there are certain guidelines about use of contingency fee contracts that will help states use such approaches where appropriate and avoid them where they are risky or dangerous.

When to Use Contingency Fee Contracts

A contingency fee contract is one where the payment is based on the contractor's performance. The contract rewards performance in cash, and the contractor has added incentive to perform. The attraction of this type of contract for revenue maximization work is that the contractor appears to take all or most of the risk. If there is no benefit, then there is no payment. And payments are financed from the benefits themselves.

This type of contract stands in contrast to fee for service contracts where contractors are paid for providing a service on a fixed basis, usually described in a proposal written in response to an RFP. Other contracting methods include cost plus fixed fee arrangements where contractors are reimbursed for their expense plus a fixed fee or profit on top of that expense. Many contracts in these latter categories include elements of contingency fee contracting, rewarding performance for production levels above a certain minimum, or releasing payments when products are delivered and approved. The discussion below can also be applied to the structuring of partial contingency contracts.

When is contingency fee contracting a good idea? Generally there are three criteria:

1. Where benefit is easy to define:

   It is essential that the benefit produced by the contractor be clear. Money benefit contracts — including revenue maximization — generally meet this first test. Examples include debt collection services where accounts are turned over to a provider for collection. The amount collected (the benefit) can be easily tracked and

calculated and paying the contractor a percentage of such collections is not necessarily unreasonable. These stand in contrast to benefits harder to define or measure — like rehabilitation success with juvenile offenders, improved safety, or therapeutic effects of service. Contingency fee contracts are possible in such situations, but they depend on the much more complex work necessary to define and quantify success and failure.

2. Where the contractor's contribution is clear:

In order to see the effect of a contractor's work it is absolutely essential to understand what happens as a result of the contractor's effort. In order to do this, the pre-existing baseline of the state's own performance must be clear so that the contractor's incremental contribution may be properly credited. This involves more than understanding historical performance and performance trends. It also requires some process for creating and agreeing to a forecast of what would happen in the absence of the contractor's work.

In some cases a performance baseline is relatively easy to establish. For example, child support accounts which have remained uncollected despite the efforts of the child support enforcement agencies can have defensible zero baselines. If these accounts are turned over to a collection agency any collection by that agency may be properly viewed as a new collection. Energy usage is another area where outcomes can be reasonably well defined. Most enterprises have well established patterns of energy usage on which to base forecasts of usage and measure the benefits of conservation measures. Revenue histories, however, are far more complex and forecasting revenue is a difficult and error prone process.

If baselines are not clear, then fee calculation and all that follows becomes a matter of interpretation and potential conflict. The benefits generated by the contractor can be extremely difficult to separate from the benefits the state would receive from its own efforts.

3. Where results are not affected by complex variables:

Finally, it is important that the contractor control the essential elements of success as nearly as possible. Incentives are only meaningful when they serve to create action and results. If the contractor is motivated by incentives, but prevented from acting, then the benefit is lost. Contingency fee contracts work best when contractors work within well defined boundaries, and are given wide latitude to produce the best possible results.

Conversely, contingency contractors find it difficult to work in complex settings where program outcomes are affected by the economy, the political process, the effectiveness of state workers, and the states changing laws and regulations. In such environments, the contractor may come to view even reasonable policy processes as inadvertent, or worse, deliberate, impediments to performance. The contractor's performance itself may be hard to disaggregate from the effects of these other variables. The contractor will find it difficult to produce the desired results, and may find it convenient to blame poor performance on variables beyond his control. Contingency fee amounts under such circumstances will be difficult to determine, at best, and subject to dispute and possibly litigation at worst.

The Risks of Contingency Fee Contracting for Revenue Maximization

In government, the combination of favorable circumstances outlined above is relatively rare. There are some areas where the performance of the contractor can be sufficiently specified that contingency fee contracts will work reasonably well. But in most revenue maximization cases, baselines are often extremely difficult to establish and there are many forces affecting performance beyond both the state and the contractor's control. Following is a listing of the risks and disadvantages of contingency fee contracting for revenue maximization:

1. <u>Contingency fee contracts create conflicts of interest between the contractor and the state</u>:

There are often conflicts over who "owns" an idea, what efforts have been made to pursue it, and who is responsible for the results. There are very few revenue ideas which do not have a long history. It is often the case that revenue proposals have in fact been proposed or tried before the contractor appears on the scene. Contractors will sometimes claim credit for the full implementation of these ideas whether or not they are fully responsible for the idea or the increase in revenue.

The question of where the contractor's responsibilities end and the state's begin create an environment ripe for conflict over who is responsible for implementing revenue ideas. For example, a contractor can run a computer tape match of two files and identify thousands of cases potentially eligible for more federal money. But someone must then investigate each case and file new claims. Does the contractor get paid for doing <u>only</u> the tape match? Is the state willing to hire staff to follow through? Is the contractor's fee discounted for the state cost? Is the contractor paid even if the state elects not to follow through (e.g., because the revenue isn't worth the cost)?

A more important conflict of interest relates to matters of policy. The contractor's proposal may save money but the state may not want to implement it for legitimate policy reasons. Matters of state revenue are almost always closely tied up with matters of public policy. There are always cases where collecting more money will stand in conflict with the interests of the state. For example, states can collect federal reimbursement on certain services if workers take time from services to track eligibility of clients and bill for services provided to children. States may not wish to have workers spend time on these functions or may opt for revenue strategies which produce somewhat less revenue but minimize intrusion on worker time. Under contingency fee contracts, the contractor may not <u>care</u> about the worker's time or the

effect on services — but only about the approach which produces the most revenue and therefore the highest fee.

Contractors will also tend to be less concerned about federal disallowances than the state. Such disallowances often take years to materialize, at which time the contractor is gone from the scene and questions of liability are difficult to unravel. The use of escrow accounts can provide some protection, but disallowance amounts are often far larger than what can be reasonably held in escrow. While reputable contractors will usually provide sound recommendations on claiming and accounting methods, the nature of contingency fee contracting rewards "short cuts" and sometimes encourages the sacrifice of the state's long term interest for short term gain.

2. Contingency fee contracts are often much more costly than other forms of contracting:

In general, states will pay more for contingency work than for the same work performed under more traditional contracting. In some cases the amount of "easy money" contractors can make under contingency fee arrangements will result in very large payments — far beyond the reasonable cost of the contractor's efforts. When this happens, such payments can become a public embarrassment to the officials who approved or sanctioned the contract.

Government revenue streams involve very large sums and fees can add up quickly. It is not unusual for revenue maximization contracts to generate fees in excess of $1 million — for work that would cost far less if performed on a fee for service basis. One approach being used by some consulting companies involves local school districts and their claims for Medicaid. Companies offer to process these claims for 20-30 percent of the amount billed. This looks reasonable to the school district — until people realize how much the 20-30 percent fee costs — and how the school district could create local jobs to do this work instead of paying an out-of-state contractor.

3. Contingency fee contracts are lawsuit prone:

The history of contingency fee contracting provides many examples of lengthy and costly litigation. The complex nature of deciding who "owns" what portion of new revenue, and the high stakes involved in such arrangements makes contingency fee contracts prone to lawsuits. This most often takes the form of the contractor suing the state for amounts payable on questionable or disputed new revenue. Since contracts can rarely be written to anticipate every possible set of circumstances, the contractor often has the advantage in such suits. General language about contractor's rights to fees can and have been applied to revenue which the state would have obtained without the contractor's assistance. Settlements of such suits can also become difficult political problems for those involved.

Conclusion

The general lesson to be taken from experience with contingency fee contracts for revenue maximization is, in a word, DON'T. There are many reputable, capable consultants who will gladly perform revenue maximization work under normal competitive contracting arrangements. Contingency fee contracting should be considered a last resort, and should only be used in those few situations where success is easy to define, where the baseline of state effort is clear, and where results are not subject to complex and changing circumstances.

If contingency fee contracting is used for revenue maximization work, such contracts should always include certain basic protections of the state's interests and rights:

- Contingency fee contracts should always include some provision for establishing a baseline forecast against which contractor performance is measured.
- Contracts should include a cap which limits reimbursement above some threshold to cost plus fee, and protects the state from excessive charges.

- Contracts should require full disclosure of actual direct and indirect costs so that "fair profit" can be calculated on an open and factual basis.
- States should always hold some funds in escrow and clarify liability for disallowances.
- And states should clearly reserve the right to disapprove contractor recommendations without penalty when they stand in conflict with the policy or fiscal interests of the state.

States have a lot to gain, and also a lot to lose, in revenue maximization efforts. It is always worthwhile to take the time to protect the state's interests and do it right.