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Is LPO Right For Your Company?

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Business & Technology Sourcing Review

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Welcome to the Fall/Winter edition of the Mayer Brown Business & Technology Sourcing Review.

As we near the close of 2008, a year marked by a turbulent global economy and momentous shifts in the political landscape, we take note of how these events are driving and shaping the sourcing and technology market. More than ever, companies are seeking to derive greater benefit from their outsourcing strategies, enabling them to operate more cost-effectively in today’s global marketplace. The goal of this newsletter is identify some of the more critical issues in today’s market and offer clarity as to their full importance.

In this issue, we cover a range of topics, including:

• The growing trend of Legal Process Outsourcing (LPO);
• Contract enforcement in China; and
• Money saving negotiating tips.

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Many corporate legal departments and even law firms in the United States are experimenting with legal process outsourcing (LPO) as a means to reduce costs and increase efficiencies without sacrificing, or sacrificing too much, the expected quality of service (QoS). The momentum behind the current popularity of LPO is a reaction to the steadily increasing legal costs in the United States and, to some extent, the economic headwinds in a faltering global economy. Global LPO growth potential may directly correlate with the overall size and projected growth in the legal services market in the United States. According to the US Census Bureau, in 2006 the legal services industry in the United States generated US$236 billion in revenue and is expected to grow steadily at a rate of more than 6 percent per year for the next decade. This sizeable market offers a ripe and lucrative environment for LPO to take hold.

To meet the growing demand for cost-effective legal services, innumerable LPO providers have entered the marketplace, resulting in the outsourcing of certain legal tasks and services. Only a few years ago, the LPO model was viewed with substantial skepticism and raised the question of whether it was “even legal,” but LPO is now viewed as a viable alternative in certain circumstances for companies’ legal needs. With that said, the framework required to properly regulate the LPO industry and to address the legal and ethical issues that are certain to arise is still in the nascent stage, but is evolving. While the US legal community has yet to take any kind of definitive stance on the viability of the LPO model, the LPO industry appears eager to embrace some form of self-regulation to establish itself.

In an LPO, a company selectively delegates certain legal functionalities and services that are traditionally performed in the United States to an LPO provider at an offshore location such as India. That provider offers the benefit of a skilled or trainable workforce that is available at wages significantly lower than those demanded by US counterparts. In other words, the basic value proposition of the LPO is that outsourced legal work is performed in the offshore
location by trained lawyers (licensed in that jurisdiction) and paralegal staff at some fraction of the cost of having the same work performed by US-based legal professionals. Services subject to LPO can range from legal coding and legal transcription to more complex projects involving legal research, litigation support, document review, contract drafting and management, legal publishing, and intellectual property-related services such as patent application preparation. In addition to the cost considerations, LPO may also enhance home-base productivity by “freeing up” the customer to focus on strategic and value-added legal work as well as to take advantage of time zone differences in offshore locations, thus enabling 24/7 operations.

Whether a real benefit is available through LPO to a specific company, however, depends substantially on a sober assessment of the company’s legal needs and requirements and whether the legal services and tasks at issue can be realistically outsourced without sacrificing important qualitative considerations; quality degradation can counterproductively result in the added cost of home-base “redo,” as well as increase the company’s risk profile. A properly performed initial assessment of the benefits and risks of an LPO, or basically an “LPO gating analysis,” should determine the answers to the questions of whether, to what extent, where and how a company may successfully deploy the LPO model to meet its legal needs consistent with its overall strategic business goals and objectives.

Companies must… carefully assess the generally applicable risks, ramifications and ethical concerns inherent in offshoring legal work that come hand in hand with the benefits of LPO.

Some of the fundamental assessments under a thoughtful LPO gating analysis include: What are the legal needs, services and requirements that may be suitable for an LPO? What are the dependencies where a complete handoff of the legal tasks and services is not possible? Are the services needed on a recurring basis (e.g., patent application preparation), a non-recurring basis (e.g., unique litigation involving facts particular to a large contract) or an intermittently recurring basis (e.g., periodic product liability claims or certain due diligence tasks associated with transactions or filings)? Do the services at issue relate to core or non-core business functionalities? Does the customer take on some level of additional risk related to the source of the need for the legal services when engaging in an LPO with respect to the services, and if so how much? How important is cost savings vis-à-vis QoS? How do the possibly outsourced services support or fit with the overall strategic corporate business goals and objectives?

As part of the LPO gating analysis, companies must also carefully assess the generally applicable risks, ramifications and ethical concerns inherent in offshoring legal work that come hand in hand with the benefits of LPO. Some of these key risks and ethical considerations include: (i) the risk of unauthorized disclosure of confidential information, (ii) liability concerns related to the unauthorized practice of law, (iii) how to protect, and avoid the
unintended or inadvertent waiver of, the attorney-client privilege and assessing whether it even would apply in the first place, (iv) the lack of robust procedures to identify and resolve conflicts of interest, (v) the recognition when applicable of the need for client consent, (vi) fee sharing arrangements and client disclosure, and (vii) compliance with export control laws with respect to offshoring information regarding US originated inventions for patent drafting services.

Most LPO demand in the United States currently involves “low-value,” labor-intensive legal services, such as legal transcription, document conversion, legal coding and indexing, and legal data entry, predominantly performed by India-based LPO providers. As the LPO industry matures, the outsourced legal work will likely move up the value chain. A research company, ValueNotes, estimates that in 2006, India’s LPO industry generated US$146 million in revenue, and projects that the industry will grow to US$640 million by 2010, by which time LPO firms in India are expected to employ over 32,000 India-based professionals. While another research company, Evalueserve, is more conservative in its LPO projections, the fact that LPO is likely to become a sizable mainstay in the US legal services market is increasingly difficult to question.

India’s emerging prominence in LPO is not surprising given the remarkably successful Indian market for information technology outsourcing and business process outsourcing (BPO). More recently, many US companies have engaged in what are known as knowledge process outsourcing (KPO) transactions, which leverage India’s vast resource of highly skilled and educated workers to perform knowledge-driven or “high end” processes that require specialized domain expertise. LPO is actually a specific example of KPO, and one for which India again offers enormous potential because of its large reservoir of English speaking lawyers and paralegals whose salary demands are extremely competitive — typically only 10-15 percent of those of their US counterparts. This professional labor pool shows no sign of shrinking; indeed, approximately 80,000 Indian lawyers graduate each year from law schools. These graduates are also particularly well-suited to service US-based legal needs because, like the United States and the United Kingdom, India’s legal system follows the common law model, and its rapidly modernizing legal and regulatory environment is based on the US/UK model of jurisprudence.

Most of the LPO demand has been met in India primarily by two service delivery models: captive centers of US corporations and law firms (such as those set up by GE, Cisco, Oracle, DuPont and Bickel & Brewer); and third-party LPO firms that provide legal services to US corporations and law firms (these firms include niche firms such as Pangea3, QuisLex and
Lexadigm that only provide legal services and multi-service firms such as Infosys and WNS, which provide legal services in addition to other BPO offerings). Variations of these models will emerge as the LPO industry matures to better service LPO customers.

Each model has its own advantages and risks that must be evaluated for a particular LPO strategy. LPO customers should adopt different delivery models taking into account numerous variables, including the nature and scope of the activities to be offshored, previous offshoring experience, a qualitative due diligence review of the potential providers’ work, concerns about security and control of confidential or privileged information, risk tolerance, tax considerations and budgetary constraints.

In sum, LPO can present a viable alternative to companies seeking to reduce their legal costs. Its usage, however, must be considered very thoroughly, and carefully take into account the circumstances and needs involved. A company considering an LPO must therefore objectively evaluate the specific and unique gating issues described above relating to the value proposition of a particular LPO, the generally applicable risks of any LPO, the offshore location and the provider involved, and the type of LPO model that best suits the needs of the potential LPO customer. ♦
Offshoring from Great Britain

Bernadette Daley

Employment issues can have a significant impact on sourcing transactions within Europe. This article examines a particular issue that has arisen in Great Britain as a result of a court case dealing with the application of the UK’s Business Transfer Regulations (TUPE) to offshoring.

European Framework

Employment issues are an important aspect of European sourcing transactions because of the legal framework that exists to protect employees when the activity in which they work is transferred. The European Acquired Rights Directive (ARD) (incorporated into UK law by TUPE) is designed to safeguard these employees so that their employment contracts and related liabilities are transferred automatically with that transfer. There are also obligations to inform and consult with affected employees before the transfer. In some countries, such as France and the Netherlands, failure to do so can mean the transfer can be delayed or even prevented. In others, a financial penalty may be incurred. For example, in Great Britain the penalty is 13 weeks’ pay per affected employee.

The ARD has not, however, been implemented or applied in exactly the same way in every European country. Although there are a number of similarities across Europe, there remain some key differences. One of these is the application of the ARD to sourcing transactions and, in particular, to offshoring.

The Great Britain Perspective

Unlike other European countries, Great Britain applies TUPE to a change in the provision of a service. TUPE can apply to a first-generation sourcing or to subsequent sourcings, including sub-contract arrangements. It can also apply if the service is taken back in-house. What is required is that immediately before the change:

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• There is an organised grouping of employees situated in Great Britain whose principal purpose is to carry out the activities (the services) on behalf of the customer. Importantly, this only requires that the employees be based in Great Britain immediately before the change, not afterwards;

• The customer intends that these activities will not be a one-off event or short-term. There is no formal definition of what this means, but it suggests an ongoing service with some element of permanence, although a contract with a term of several years is likely to be caught;

• The activities do not consist wholly or mainly of the supply of goods for the customer’s use. There may be a fine line here as to whether something constitutes the supply of goods or the supply of a service which may be connected with those goods. For example, simply supplying food may not be caught but supplying a catering service probably will be caught.

TUPE and Offshoring

It is accepted that TUPE can apply to sourcing transactions within Great Britain. The debate in Great Britain now focuses on whether TUPE applies to offshoring, particularly to a country outside Europe that does not have equivalent ARD provisions and employee protections.

This debate is rarely played out in the English courts because, in practice, employees tend to be made redundant, and the incoming and outgoing parties carve up associated costs as part of the commercial arrangements. Employees and their representatives, if treated fairly, have not felt it necessary to press the point. However, this question surfaced in the Holis Metal case, which was heard by the Employment Appeal Tribunal (EAT), the appeal court for UK Employment Tribunal claims. This was the first time that this question has been considered by the English courts.

In Holis Metal, an Israeli company bought a business that was based in Great Britain. After the transfer, the business was moved to Israel. None of the employees transferred there and all were dismissed by the buyer. At the first stage, the Employment Tribunal found that, because the transfer and the redundancies took place in Great Britain, that was enough to trigger the application of TUPE, and what happened afterward was irrelevant. The decision was upheld on appeal.

As this was the first time this issue had been debated in a court case, the EAT was asked to give a non-binding view on the wider question of whether TUPE could ever apply in these circumstances.

The EAT had no hesitation in deciding that the ARD and TUPE can apply to offshore transfers of businesses and activities situated in Great Britain before the transfer. Given that
the purpose of the ARD and TUPE is to protect the rights of employees, they should still be protected if the transfer occurs across the borders outside Europe.

Impact
The EAT decision on this narrow point is in our view correct. On the wider issue, the decision is interesting as it sets down the English courts’ likely approach. However, that part of the decision should be treated with some caution, even though arguably right, because the comments were not necessary to the decision.

There remain some unanswered questions, particularly whether employees are transferred under TUPE to the offshore country and how an employee can enforce any claims they might have against an offshore entity, particularly if that entity has no corporate presence in Great Britain for it to be sued.

In practice, we do not expect that the decision will affect significantly the way employers negotiate their deals. What it does mean is that they will need to take greater care to comply with their consultation obligations under TUPE.

Several options are available when faced with an offshoring situation:

- **No TUPE**: You agree that, due to the facts of the particular transaction, TUPE does not apply. In this case, employees are likely to be made redundant by the incumbent employer, who will need to carry out a redundancy consultation exercise. The parties can agree how they will deal with any employee claims made and any associated costs and liabilities.

- **TUPE applies**: You agree that TUPE does apply and that employees and related liabilities will transfer. If the new service provider wants to make employees redundant, then it can do so after the transfer, following a redundancy consultation exercise. If it wants those redundancies to take effect on the transfer, then in practice the customer on a first-generation outsourcing will need to manage that exercise on behalf of the service provider. However, the customer is likely to seek indemnity protection for any claims that might arise as a result, unless this has already been priced into the deal.

- **TUPE applies, with redundancies pre-transfer**: In practice, what tends to happen is that the parties accept that TUPE applies and they inform and consult with employees, or their representatives, accordingly. Given the likelihood that most employees will not want to transfer and either relocate offshore or face the risk of redundancy soon afterwards, redundancies usually take effect on or before the transfer. Some employees may be re-deployed. This process is often managed by the customer on a first-generation outsourcing but in conjunction with the service provider. The less hostile way to do this is to offer employees
the option of relocating offshore (generally on worse employment terms) or taking voluntary redundancy (severance). In addition, employees can be asked to “opt out” of the TUPE transfer, which is a right they have under TUPE and which operates like a voluntary resignation. Employees are not likely to agree to do this unless they are happy with the rest of the package on offer. The parties can also agree how they will carve up associated costs and liabilities.

These options become progressively more difficult to operate in practice on a second or subsequent generation outsourcing, unless the relationship with the incumbent service provider is good and it is prepared to co-operate.

If 20 or more employees are being made redundant within a 90-day period, Great Britain requires a minimum consultation period of 30 days. If there are 100 or more redundancies then this is a minimum of 90 days. The penalty for failing to do this is an award of up to 90-days’ pay, together with the risk of related claims for unfair dismissal, for those who have one year of service or more. This will need to be factored into the time frame for the transaction. The consultation procedure differs significantly among European countries and has different consequences. Overall, the message is to make sure the consultation process has been completed before a commitment is made to proceed. ♦

**Endnotes**

1 Holis Metal Industries v GMB and Newell – UK EAT/0171/07CEA.
Effective Enforcement of Contract Rights in Chinese Sourcing Contracts

Geofrey L. Master
R. Terence Tung

Effective enforcement of contract rights is on virtually every customer’s short list of concerns when considering sourcing goods or service from providers in China. As China looks to build on its position as a manufacturing powerhouse and become a global player in the services industry, providing assurance to customers that they can effectively enforce contract rights in Chinese sourcing contracts stands as a key challenge to success.

In considering the issue of contractual enforcement, focus often tends toward dispute resolution mechanisms utilized either to compel performance in the face of actual or threatened non-performance, or to address damages or other remedies for a failure in performance. Such a focus tends to emphasize the traditional means of dispute resolution, including mediation, arbitration, litigation and injunctive relief, together with satisfaction of awards and judgments. However, while the availability and effectiveness of such dispute resolution forms a critical component of contract enforcement, actual dispute resolution alone is far too narrow a focus for evaluating effectiveness of contract enforcement. Rather, effective contract enforcement should be viewed on a broader systematic basis, as a part of the overall contractual arrangement and context. Such a perspective includes not only the legal environment of the contract (which would include the availability of traditional dispute resolution mechanisms), but, significantly, also contract-specific considerations such as the structure of performance established under the contract, as well as extra-contractual considerations such as the broader relationship between the parties and the market visibility and reputation of the provider.

This article will identify some of the important considerations facing customers in evaluating effective enforcement of sourcing contracts with Chinese providers. The objective will be to assist would-be customers in evaluating the viability of sourcing arrangements with Chinese providers.

Geof has broad experience in outsourcing and procurement transactions, including the outsourcing and offshoring of business processes and functions, as well as information technology and services. Geof’s clients have ranged from start-up enterprises to national and global firms and government organizations.

Terence acts for foreign companies in labor dispute matters and has substantial experience with the litigation and arbitration of cases involving commercial, contractual and banking disputes throughout Mainland China and in Hong Kong.
Inventory of Considerations – Acceptance of Relatively Few Absolutes

In evaluating the viability of any sourcing opportunity, a customer inevitably balances the criticality of specific contract compliance with the reality of contractual performance. In jurisdictions with reasonable predictability and assurance of contract enforcement, the evaluation can often be relatively straightforward, although never completely without risk. This assessment, then, is ultimately one of determining whether a particular product or service sourcing arrangement meets that customer's acceptable risk profile. Such analysis is a challenge in any market environment, but particularly so in the rapidly evolving market of Chinese providers.

Enforcement mechanisms available for a sourcing contract can be divided into two major groupings. The first relates to the structural and operational factors established both by contract and by extraneous contractual environmental considerations. These factors focus more on operational safeguards and mechanisms providing practical protections to assure performance, and less on actual enforcement. The second is composed of the more traditional enforcement mechanisms; in China, as in any commercial jurisdiction, these focus on the traditional dispute resolution considerations. It is with this second grouping that China offers particular challenges, evidenced graphically with its only very recent embrace of rule of law concepts.

China is seeking to create an environment of predictable legal enforcement of contract rights. Despite significant strides toward developing a predictable environment of contract enforcement that is accepted at international commercial standards, this remains a new endeavor with less certainty than in countries with a longer commercial practice environment. This reality in China means that the first grouping (contract structure and operational arrangement) has heightened significance for sourcings from China.

Contract Structure and Operational Arrangements to Avoid Disputes

Some of the most effective contract enforcement techniques in sourcing transactions have been dispute avoidance strategies reflected in the scope, structure and operation of the sourcing relationship. Savvy buyers of products and services have long worked to scope and structure their sourcing arrangements to avoid or minimize the likelihood of disputes and to eliminate high-risk situations. No matter how sophisticated and established the dispute resolution environment, actual dispute resolution activities in fact are ultimately distracting, costly and non-productive.

The following are examples of approaches and arrangements designed to avoid problems in the first place:

- Payments tied to actual delivery and acceptance by buyer
• Strategic scoping of the sourcing so that buyer retains control of the overall production/performance process (e.g., limit sourcings to discrete components or utilize multi-supplier arrangements)

• Careful due diligence in supplier selection and monitoring (e.g., to ensure supplier possesses a reputation and operation which it is motivated to preserve and protect)

• Effective audit and quality control rights, including inspection and reporting

• Effective and legitimate utilization of business incentives (e.g., retention or expansion of business)

These approaches and arrangements, developed over the years as simply good practice in any sourcing transaction, are available and take on added importance when sourcing in China, where the options and mechanisms of dispute resolution may be less developed and certain.

Dispute Resolution Considerations in China

Despite best efforts to scope, structure and operate sourcing relationships to avoid the need to resort to active resolution mechanisms, disputes requiring formalized process between buyer and supplier can and do happen. In the case of Chinese providers, all of the basic dispute resolution options are available in China. In some cases, however, these options present unique requirements and considerations.

When it comes to active dispute resolution, alternative dispute resolution, from structured internal escalation to mediation and even arbitration are all available and typically well-suited to address disputes with Chinese suppliers. From a cultural perspective, informal dispute resolution tends to be more consistent with important elements of Chinese culture and tradition, including Confucian ethics and the overall desire for harmony. Consequently, among sourcing arrangements with Chinese providers, we see a marked preference to resolve disputes through alternative dispute resolution efforts rather than litigation. In fact, public litigation historically has carried a connotation of criminal proceedings in China, viewed as humiliating to the parties involved. This background sets a reasonable stage for the well-structured but informal dispute escalation procedures that are often included in larger sourcing arrangements (whereby each of the parties has contractual obligations to address disputes and escalate them within their respective management in an effort to resolve the matter before resorting to more formal proceedings), as well as somewhat more formal mediation arrangements.

Nonetheless, resort to formal dispute resolution proceedings may be inevitable, and a buyer sourcing from a Chinese supplier must account for this possibility. In this regard, both litigation and arbitration are available methods of dispute resolution with Chinese suppliers, but each
carries important considerations and qualifications. Further, subject to certain important limitations, the sourcing contract between a Chinese provider and a foreign customer can provide that the law governing the contract be other than China’s, and that any disputes under the contract be resolved through proceedings conducted outside of China. Two important areas of limitation, however, must be noted here:

- Despite a contract’s generally valid choice of law, some issues remain subject to Chinese law, including certain issues concerning intellectual property ownership, labor laws, land ownership, insolvency and enforcement of foreign judgments or awards; and
- Courts in China are much more likely to enforce a foreign arbitral award than the judgment of a foreign court.²

Litigation in China

Since 1979, China has had a judicial system that will hear and resolve commercial disputes. However, beyond the standard concerns of litigation in even more established judicial environments, including inefficiency, cost and time, commercial litigation in China raises a number of significant concerns — many related to the lack of a litigation tradition for resolving commercial disputes and the relative infancy of its judicial system.

Practically speaking, there are three types of arbitration recognized in China: domestic arbitration, foreign-related arbitration and foreign arbitration.

20 years, China enacted a comprehensive arbitration law in 1994, which, together with a number of opinions issued by the Supreme People’s Court, in many ways meet international arbitration law standards both in scope and content.

Practically speaking, there are three types of arbitration recognized in China: domestic arbitration, foreign-related arbitration and foreign arbitration. The first two describe proceedings that are conducted and enforced in China under Chinese laws, while the latter refers to an arbitration conducted outside of China, but enforceable within China under the New York Convention.⁴ For arbitrations taking place in China, designation as “foreign-related” can offer the parties broader options and, thus, the characterization can be an important consideration. A dispute meeting one of the following elements would be expected to be recognized as “foreign-related” by Chinese courts:⁵

- One or both parties in the dispute are foreign persons, or a company or organization domiciled in a foreign country
- The subject matter of the dispute is located in a foreign country
- The facts that establish, change or terminate the contract between the parties occur outside of China

For a variety of reasons, including concerns about China’s still-developing judiciary,³ arbitration is becoming the predominant formal mechanism for resolution of contract disputes in China. As part of its sweeping enactment of commercial laws over the past
A potentially significant qualification with respect to the dispute characterization issue is the fact that, for this determination, both foreign-invested enterprises (FIEs) and wholly foreign-owned enterprises (WFOEs) are considered Chinese persons because they are Chinese-formed entities. While it is not a prerequisite that a local entity be formed and utilized in sourcing transactions by foreign customers, one or the other of these structures is a frequently used vehicle for a variety of local operational reasons. Sourcing transactions in which such entities are frequently used include shared services captive structures. In such cases, use of one of these entities increases the likelihood that a foreign buyer may, as a result of its utilization of an FIE or a WFOE structure, find its contractual obligations with Chinese providers governed by Chinese law and any disputes characterized as “domestic.”

The consequence of this can be significant. For example, in both a recognized foreign-related arbitration and a foreign arbitration, the scope of the People’s Court ability and willingness to deny enforcement is far narrower than in a domestic arbitration. The People’s Court may deny enforcement of a domestic arbitral award if it finds there was insufficient evidence or that the law (which would necessarily be Chinese law) was erroneously applied. Neither of these defenses would be available to deny enforcement in a foreign-related arbitration or in a foreign arbitration. Accordingly, there is far less certainty regarding judicial enforcement in the case of Chinese domestic arbitrations, which may defeat the entire objective of arbitration.

The main commission for conducting foreign-related arbitrations in China is the China International Economic Trade Arbitration Commission (CIETAC), which is a state-sponsored organization that was formed in 1956. Despite significant modernization of its procedures in recent years, CIETAC proceedings continue to be viewed with some concern by the international business community. These concerns include issues about transparency of arbitrator compensation and even the possibility of improper influence and pressure being brought on the arbitrators.

Ultimately, however, to the extent a dispute results in an award or a judgment, a range of issues arises associated with the enforceability of that award or judgment against a Chinese supplier, irrespective of the forum proceeding or governing law applied. Applications for enforcement of arbitral awards are made to local intermediate Chinese courts and there is no official statistical report on enforcement, so the level of enforcement is uncertain. However, the basis of non-enforcement of otherwise enforceable arbitral awards is limited to procedural violations, such as:

- Lack of jurisdiction of the arbitration proceeding;
- Lack of valid arbitration agreement; and
- Discrepancy in the proceeding, such as improper appointment of an arbitrator or lack of notice to a party.

Finally, the most common reason for non-enforcement of arbitral awards (domestic and foreign-related) is a universal one: lack of assets. Such a situation may involve actual bankruptcy or insolvency, but often it includes those cases where the plaintiff or court simply could not locate assets.
Conclusion

Enforcement of contract rights is a critical consideration in any commercial transaction. As China looks to increase its role as a supplier of products and services to the world, the efficient and predictable resolution of disputes will develop, and as it does, the scope of sourcing transactions viewed as viable with Chinese providers will increase. In the meantime, companies looking to source from Chinese providers must not only carefully consider the scope and structure of their arrangements, but also carefully assess the effectiveness of options available to them in the case of a dispute and the importance of that effectiveness. In many senses, this consideration is no different from any sourcing arrangement in any country. China, however, presents certain unique challenges. These challenges stand, however, with significant opportunities with Chinese providers. With careful consideration and planning, companies can approach the Chinese market with a level of confidence that will enable them to take advantage of the many and growing opportunities in what is, and promises to remain, one of the most dynamic markets in the world.

Endnotes


2 As a signatory to the New York Convention, the courts of China are obligated to recognize and enforce arbitral awards of other signatory countries, including the United States. On the other hand, the United States and a number of other countries have not signed treaties on recognition and enforcement of foreign judgments, and consequently Chinese courts have no similar obligation to enforce court judgments of those countries.

3 Beyond issues associated with its newness alone, including experience of judges, issues of concern include the means of appointment and compensation of judges and the overall level of qualification in many parts of the country.

4 The following table describes these distinctions:

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<th>Domestic Arbitration</th>
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<td>Conducted by a foreign arbitration institution</td>
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<td>Enforceability in China</td>
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<tr>
<td>Applicable legislation or convention</td>
<td>Arbitration Law and Civil Procedure Law</td>
<td>Arbitration Law and Civil Procedure Law</td>
<td>New York Convention</td>
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5 These elements were adopted by the Supreme People's Court in defining “foreign-related civil litigation” in a 1992 opinion. No such specific guidance has been given for “foreign-related” arbitration, leaving the matter less certain. Further, under Article 20(7) of the Consultation Draft of the Provisions for Handling of Foreign and Foreign-related Arbitration Cases by the People's Court (31 Dec 2003), there would appear a likelihood that an agreement between parties for arbitration outside of China may be found void if there is no “foreign element.”

Securing Personal Private Information: Does Your Contract Do the Job?

Rebecca S. Eisner

Privacy and security compliance requirements are rapidly changing. Businesses face not only fines but also regulatory scrutiny and other penalties for improperly securing personal information, not to mention the reputation and customer loyalty damage incurred as a result of security breaches. Further, these risks apply whether the data is on your system or on one of your vendors’ systems.

Faced with these risks, now is a good time to review and update your existing sourcing agreements and forms to ensure that you are protecting personal data (that is, data about an individual). Here are five quick adjustments to consider making to your sourcing agreements.

Make sure you cover database breach incidents. Database breach notification laws are in place in a majority of US states. They cover security breaches as well as loss or disclosure of personal information. If you have an older agreement, database breach incidents may not be covered or contemplated in your agreement. Sourcing agreements should require suppliers to provide immediate notification to the customer in the event of a security incident that potentially compromises personal data. Suppliers should also be required to cooperate with investigations, reporting and general compliance, and to fix the problems that enabled the incident. Consider which party should pay for credit monitoring services, fines, penalties, investigation costs and related damages arising from the security breach.

Know where your personal data is, and where it’s going. As the customer, you need to know where your supplier will be storing and processing your personal data. If an onshore provider sends data offshore, the effect is that you have an offshore agreement. Offshore agreements may require additional protections. In addition, if you are subject to data protection laws, such as those in the European Union, you cannot transfer personal data to certain countries without satisfying EU requirements. Make sure your contract covers where your personal data can be processed and stored.

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Rebecca’s work focuses on business and technology matters, including sourcing and outsourcing, information technology transactions, e-commerce, privacy, and security. She regularly advises clients on such issues as data transfer and privacy, electronic contracting and signatures, and web site design and review.
Personal information should not be treated like regular confidential information. Personal data is not regulated like regular business confidential information. Therefore, personal data must be more tightly controlled than regular confidential information, which is often subject to standard exclusions. For example, you would not want confidentiality to expire on personal information after three or five years, as many standard confidentiality clauses for regular business information provide. If applied to personal information, standard exclusions like this one can lead to unintended results.

If supplier only “complies with applicable privacy laws,” customer may not be in compliance. The majority of privacy laws and regulations apply not to suppliers but to customers. Your contract must require your suppliers to comply with those laws applicable to them, and to assist you in complying with those laws applicable to you. Customers should define the privacy requirements, and suppliers should implement processes and procedures designed to ensure compliance.

“Reasonable security measures” and “industry standards” are scant protection. General contract terms about security compliance may offer some protection, but they may be insufficient because they are too high-level. Be specific. Specify the requirements for privacy compliance and minimum security measures. Attach those requirements to the agreement or incorporate the customer’s own requirements into the agreement. Remember that they may need to change from time to time.

It is vital that businesses continuously monitor legal developments and adjust sourcing agreements to stay in step with best privacy and security practices. These five quick adjustments can help you to keep your personal information secure, and help you to stay in compliance with privacy laws. ♦
Data Security Updates: Two States’ Approaches
Joseph M. Pennell, Associate, Chicago

Massachusetts Issues Comprehensive Data Security Regulations
On September 29, 2008, the Commonwealth of Massachusetts issued comprehensive regulations designed to safeguard residents’ personal information. The regulations become effective on January 1, 2009, and apply to businesses and individuals “that own, license, store or maintain personal information about a resident of the Commonwealth,” regardless of any physical presence within Massachusetts. 201 CMR 17.00. These regulations, therefore, may have implications for businesses across the country. Affected businesses must enact a broad information security program with detailed “administrative, technical, and physical safeguards” to prevent unauthorized access to personal information.

PERSONAL INFORMATION
Under the new regulations, personal information is defined as a person’s first name (or initial) and last name in combination with either a Social Security number, a driver’s license number, a state identification card number or a financial account number (e.g., a credit card number). Personal information does not include information that is publicly available.

ENCRYPTION AND SECURE ACCESS
The new regulations mandate encryption of all personal information transmitted wirelessly or over public networks, to the extent that such encryption is “technically feasible.” Furthermore, all personal information stored on portable devices (e.g., laptops and flashdrives) must be encrypted as well. Encryption is defined as:

- the transformation of data through the use of an algorithmic process, or an alternative method at least as secure, into a form in which meaning cannot be assigned without the use of a confidential process or key...

Other requirements include the use of secure passwords, monitoring for unauthorized access, and information security training for employees.
ADMINISTRATIVE REQUIREMENTS

The regulations require businesses to develop, implement and monitor a “comprehensive, written information security program” for the protection of personal information. Companies must identify, assess and mitigate potential risks to the security of personal information. Furthermore, the security programs must limit the amount of personal information collected and the amount of time that information is stored.

Before a business may share personal information with third-party service providers, those providers must certify that they have a comprehensive information security program. Additionally, businesses must contractually require that those providers maintain compliance with the regulations.

Companies must update their information security program annually, or more frequently if monitoring shows that their program is no longer sufficient. Security breaches, and corresponding corrective actions, must be documented as part of these programs as well.

CONCLUSION

The broad scope of these regulations has implications for businesses across the country that possess personal information pertaining to Massachusetts residents. Affected businesses should carefully plan “comprehensive, written security programs” that satisfy the baseline requirements of these regulations while also addressing security challenges unique to their specific organizations.

Nevada’s New Data Security Law: Encryption of Personal Information In Transit

Companies doing business in the state of Nevada are now required to encrypt customers’ personal information while that information is in transit (as defined below). Historically, the Nevada Supreme Court has held that companies with significant contacts with Nevada are “doing business in the state,” even if their headquarters or offices are located out of state. As a result, this new law may affect companies across the country.

Unlike data security regulations recently enacted in Massachusetts, the Nevada encryption law contains relatively few details: “A business in this State shall not transfer any personal information of a customer through an electronic transmission other than a facsimile to a person outside of the secure system of the business unless the business uses encryption to ensure the security of the electronic transmission.” Nev. Rev. Stat. 597.970. Curiously, the law’s scope is limited to personal information “of a customer,” excluding from protection other personal information a business may possess (e.g., employee personal information and third-party supplier personal information). This narrow focus could result in weaker protection for significant amounts of non-customer personal information in a business’s possession.
The law (Nev. Rev. Stat. 205.4742) defines “encryption” as:

the use of any protective or disruptive measure, including, without limitation, cryptography, enciphering, encoding or a computer contaminant, to:

1. Prevent, impede, delay or disrupt access to any data, information, image, program, signal or sound;

2. Cause or make any data, information, image, program, signal or sound unintelligible or unusable; or

3. Prevent, impede, delay or disrupt the normal operation or use of any component, device, equipment, system or network.

Personal information protected by the law includes a person's first name (or initial) and last name in combination with either a Social Security number, a driver's license number, a state identification card number or a financial account number (e.g., a credit card number). Significantly, for a financial account number to be considered personal information, it must be accompanied with any PIN, access code or password necessary to access the account. Publicly available information, as well as the last four digits of a Social Security number, are not considered personal information. Nev. Rev. Stat. 603A.040.

**IMPLICATIONS UNDER THE EXISTING NEVADA DATA BREACH NOTIFICATION LAW**

Since January 1, 2006, Nevada law has required companies to notify customers when a security breach has resulted in unauthorized disclosure of their personal information. Nev. Rev. Stat. 603A.220. Notification is only required, however, if this personal information was unencrypted at the time of the security breach. Therefore, if a company suffers a security breach while unencrypted personal information is in transit, that company is, in effect, obligated to notify affected customers (i.e., potential plaintiffs) that it has violated Nevada's new encryption law.

**CONCLUSION**

Under the Nevada courts' broad interpretation of what constitutes “doing business” in the state, companies across the country may be affected by Nevada’s new encryption law. To avoid potential liability, affected businesses should take steps to ensure customers’ personal information is encrypted before it is transmitted or transferred. ♦
Negotiating Sourcing Contracts That Save Money
Brad L. Peterson

Outsourcing has deep roots as a tool for saving money. However, maximizing savings on an enterprise level while addressing the risks requires thoughtful, careful, and sometimes very creative deal structuring and negotiation. Here are twelve key steps for outsourcing customers whose top priority is reducing costs:

**Start with a strategy.** Tactical or “deal-by-deal” outsourcing leaves expensive gaps and overlaps between deals. Strategic outsourcing maximizes savings at the corporate level by consolidating enterprise volumes and efficiently allocating work between internal and external providers. Ergo, an outsourcing program led from the top will save more than many outsourcing projects led from the business units.

**Align internally.** Cost savings must be balanced with other goals, such as transformation, quality, treatment of affected employees, and access to scarce skills. Unless your company knows what it is willing to sacrifice to save money, the negotiation team will be unable to send the right RFP with the right message to the right suppliers and focus negotiation energy on the right points.

**Define scope carefully.** Cost-focused outsourcing means that you’ll have a cost-pressed supplier. A cost-pressed supplier will tend to provide only those services that are clearly within scope and to seek to recover margin on change orders needed to expand the scope to cover missing items.

**Focus on value.** Though our industry’s maxim is “better, faster, cheaper,” consider a maxim like “worse for less.” One of our clients cut its in-scope IT costs in half by replacing its world-class internal service levels with “good enough” service levels. Others have saved large amounts by sourcing multiple quality levels, using “gold” service only where its value matches its cost, or by using a supplier’s standard offering instead of having the supplier meet the customer’s unique needs. The key to success is to focus on maximizing value instead of on replacing internal services.

*Brad represents clients in a broad range of onshore, nearshore and offshore business process sourcing transactions out of the Chicago office. These transactions have included sourcing functions such as human resources, finance and accounting, logistics, contact centers and back-office processing.*
**Structure to save cash now.** You can structure outsourcing deals to reduce first year costs by, for example, spreading one-time costs over the life of the transaction, deferring payment, and selling assets to the supplier. Each of these structures involves long-term costs, such as high termination charges and an implied interest rate on the deferred payments. However, there are years — and 2009 may be one of them — when those might be small prices to pay.

**Take more risk.** A supplier’s price consists of cost, profit and a risk premium. You can reduce the risk premium by asking for less commitment from the supplier. On pricing terms, for example, you could allowing cost-of-living and currency fluctuation adjustments or even re-pricing options. Operationally, you could accept weaker commitments to technology currency or continuous improvement. On legal terms, you could forego some termination rights, accept weaker indemnities or grant more limitations on the supplier’s liability.

**Offer more reward.** Suppliers have the ability not only to lower their own charges but also to measurably reduce other costs. For example, a facilities management supplier can reduce utility bills, an F&A supplier can reduce working capital carrying costs, and a procurement supplier can reduce costs for procured goods. Sharing these savings creates incentives for the supplier to maximize them.

**Use competition.** Competition works particularly well when the goal is clear and measurable, as with sports and savings-focused contracts. Smart companies use a competitive process to award work, and do so as part of a multi-supplier sourcing program that continues competitive pressure during the contract term. If ongoing competition cannot be maintained through multi-supplier sourcing, customers can seek to use benchmarking and re-bid rights, though those have notable difficulties.

**Negotiate a tight contract.** During negotiations, it can be tempting to just “get the deal done” and leave the minutiae to be sorted out later as the agreement is implemented. Unfortunately, sorting out minutiae with a cost-pressured supplier, after the customer’s negotiation team moves on to the next project, generally means that value leaks from the customer to the supplier.

**Analyze all of the costs.** Saving money is not about getting the lowest contract charges — it’s about reducing total costs. Suppliers can easily reduce their “headline” charges by pushing costs to the customer. Thus, the financial analysis must also consider items such as the costs of fulfilling customer responsibilities, paying third-party charges, complying with relevant laws, paying taxes, providing facilities, and addressing employee obligations. To gather the right information, the financial analysts will need to work closely with operational, technical, user, procurement and legal team members.
Pay only agreed charges. For customers, a well-crafted contract states all of charges. There are no blank checks, no opportunities for the supplier to re-open the price, and no additional opportunities for charges. Thus, there should be no surprises. Following that up with careful contract management is essential because the supplier will naturally invoice somewhat in accordance with its preferred practices instead of the cost-focused contract until the differences are made clear by the customer.

Keep improving the deal. You never know all you would like to know when you are negotiating a contract. Within months, new information will come to light that will create opportunities for mutual gain by modifying the contract in ways both large and small. What you see as problems in the contract may in fact be opportunities for value-adding trades, and requests from the supplier for waivers should be considered openings to propose those trades. Careful documentation will preserve the benefit of those trades.◆
The Disciplined Path: A System Dynamics Approach to Complex Outsourcing Challenges
Doug Plotkin, PA Consulting Group
Scott Friedrichs, PA Consulting Group

A Brief History of Outsourcing

Information technology (IT) outsourcing continues to evolve. Initially, outsourcing was driven by a company’s need to cut costs, improve speed to market and service levels, and gain access to specialized IT skills. Corporations outsourced selected IT functions or “towers” to the larger IT companies that dominated the field. As companies never expected to operate these towers again, they signed long-term agreements and turned over management and architecture control to the vendors.

Early outsourcing deals, commonly referred to as “First Generation” or “Static” deals, were seen as one-offs. A single tower was outsourced, and management’s decision was considered independent of the company’s strategic intentions, the broader business environment or other trends within IT. Management’s goal was to create the best outsourcing arrangement, and live with that decision for the duration of the deal.

Many early deals underperformed due to the vendor retaining managerial and architectural control for the tower, effectively removing all strategic decisions from company managers. Companies found themselves locked into long-term agreements without adequate escape clauses. Over time, outsourcing contracts became shorter in duration, began incorporating governance clauses to handle deal terminations and retained for companies the critical decision-making elements for the outsourced tower.

The Second Generation

During the “Second Generation” phase, existing deals were renegotiated, terminated or sourced to another vendor because the first contract was at its natural end, cost savings diminished, company strategy shifted or vendor performance forced a change.

Offshoring gained favor as application development became outsourced to overseas facilities. To counterbalance offshoring, companies began to build “captives” (their own overseas delivery facilities) as alternatives.

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Companies began to look beyond IT for outsourcing arrangements and many business processes, including Human Resources, Finance and Accounting, Facilities and Legal services, were outsourced.

Even with the scope of outsourcing expanding beyond IT and offshoring coming into play, the “Second Generation” remained only a slightly more complicated version of “Static” outsourcing. Work was still grouped into towers, with each tower’s merits evaluated independently based on a snapshot in time.

**Dealing with Today’s Market Complexity**

The global marketplace is driven by technology innovation, changing customer needs and globalization. Electronic business structures, rapidly fluctuating and integrated capital markets, emerging communication channels and regulatory compliance are key characteristics of today’s markets.

The speed of interactions within the marketplace has made the danger of miscalculating an outsourcing decision simply too great and caused companies to reassess their approach to Static outsourcing. Companies are faced with complex issues that cannot be analyzed using the Static outsourcing tools and methodologies so common in the industry. For example:

- How does one determine the optimal mix of outsourcing, insourcing and re-sourcing over various deal lengths and geographies, while reacting to changes in corporate strategy and the competitive landscape?
- What second order effects will a change in one area of the outsourcing strategy have on another, given the functional dependencies that did not previously exist?
- When should an outsourcing agreement, which is delivering smaller benefits than one could get elsewhere, be terminated taking into account vendor switching costs?

Static outsourcing strategies must adapt to become successful in today’s market. Strategists are advocating a new outsourcing strategy built around an “adaptive infrastructure” model, which allows for increased complexity along several dimensions to be factored into an outsourcing decision.

**Time.** The speed of change demands that companies adapt their strategies and operations over much shorter timespans — spans that evolve within the time horizon of typical outsourcing deals.

**Functional interdependence.** The simplifying assumption of “functional independence” between towers no longer holds; there are too many interfaces within the business and between vendors to treat each outsourcing decision independently.

**Geographic reach.** Options for outsourcing now span the globe, introducing elements of cultural, political and regulatory risk that vary over time, and must be factored into outsourcing decisions.
Continuing to use a Static outsourcing strategy, which ignores these factors, will have a devastating effect on your company.

How, then, should a company handle outsourcing complexity and minimize the threat of paralysis within the marketplace?

**Introducing System Dynamics**

An outsourcing methodology known as system dynamics (SD) has emerged to assist companies in evaluating and categorizing their outsourcing options. SD explicitly defines the cause-effect relationships, interdependencies and feedback mechanisms in place within the company and its broader operating environment. More importantly, SD accounts for delays between the time a decision is made and when its full consequences are realized.

Incorporating SD into outsourcing decisions allows companies to rigorously evaluate the consequences of different combinations of sourcing and how the consequences change when implemented under different timing.

The first step in the SD process involves creating an extensive cause-effect model that graphically describes the key interdependencies between the business, its vendors and the operating environment. These cause-effect relationships drive business performance over time, including the unintended consequences that are hard to infer based on intuition alone.

System dynamics explicitly defines the cause-effect relationships, interdependencies and feedback mechanisms in place within the company and its broader operating environment.

The next step is to quantitatively define these cause-and-effect connections in a series of interlinked mathematical equations that are validated numerically against past performance indicators. The resulting mathematical model serves as the analytic engine for assessing the simulated impact of different sourcing options throughout the sourcing lifecycle and across vendor solutions.

The mathematical model operates on key assumptions, which describe how things will change under the outsourcing agreement.

Assumptions take into account:

- Bundles of activities or towers sourced
- Desired deal structured outcome (i.e., insource to outsource, or offshore to near shore)
- Number of vendors involved
- Timing of deal
- The degree of change, and the likely disruption to business
• Relative capability, capacity, and cost of current and potential providers

The assumptions feed into the model and the model’s internal logic calculates the consequences — both intended and unintended — of these changes on business performance over time. Model outputs can include graphical trend charts showing changes in profit over time, changes in deal value for assumed termination conditions, cost and savings drivers, and causal diagnoses of unexpected behaviors.

Together, the mathematical model, scenario assumptions and outputs form a decision framework a company can use to evaluate its different outsourcing arrangements.

Incorporating SD modeling into outsourcing decisions adds additional rigor and flexibility to the outsourcing process by allowing companies to more explicitly evaluate:

• The optimal time to terminate an existing arrangement while balancing the penalty for termination vs. the value to be gained from switching (net of switching costs).
• How the “termination sweet spot” moves if the current provider increases its value over time by transforming itself and passing along the benefits.
• Where the point of diminishing returns to further outsourcing will likely occur, given constraints posed by the business, labor, and regulatory environments.
• The value (e.g., cost avoided or profit gained) of “selective sourcing” (i.e., using multiple best practice providers) vs. staying with, or moving to, a single provider.
• The savings of using a “phased” approach, whereby parts of the current agreement are terminated and moved in one year, other parts are improved under the current provider, and different parts are moved or improved in yet another year.

Conclusion

In today’s outsourcing world, where everything is on the table from multiple towers and business processes to timing, geography and interdependencies, the static outsourcing models of the past are insufficient to optimally evaluate a company’s best approach to outsourcing. Complex sourcing decisions require a dynamic methodology for:

• Identifying the key questions to answer as part of strategic sourcing decisions;
• Improving the big picture perspective;
• Enhancing the ability to balance near-term actions with long-term consequences;
• Enabling rigorous evaluation and productive discussion; and
• Tracking all the sourcing decision elements and how they vary over time

Switching to a System Dynamic methodology will provide additional discipline to assist companies in making sense of their operating environments and improve their ability to address the complex and evolving outsourcing challenges.
Case Study: London Underground Outsourcing of Infrastructure Upgrades and Maintenance in a Public-Private Partnership

Doug Plotkin, PA Consulting Group
Scott Friedrichs, PA Consulting Group

Background

In 1997, the UK Government sought to make up for years of under-investment in London Underground Limited (LUL) and reduce its reliance on public funding. It directed LUL to investigate restructuring options, including outsourcing elements of Underground infrastructure and operation to the private sector.

LUL needed to determine how different options would affect major Underground stakeholders — LUL itself, its workforce, London’s traveling public, the Government, and the private sector. A particular challenge here was the breadth of change accompanying restructuring. LUL knew that elements of its business, such as ridership levels, revenue, investment, asset condition and staff performance, were all linked, and that their interaction would determine future system performance. But there was no strategic, integrated system-wide view of the Underground and its stakeholders to evaluate consequences of potential changes.

LUL engaged PA Consulting Group to evaluate potential outsourcing strategies, using System Dynamics to model LUL’s operations, its customers and their choices, and competing transportation modes.

Evaluating Outsourcing Options and Critical Aspects of Implementation

The model was first used to evaluate structural options for outsourcing elements of the Underground. A high level view of the model is shown below.
Analysis showed that, discounting options that offered high risk without commensurate return, the way in which the new structure was implemented was more important to success than the choice of option. In 1998, the UK Government decided to restructure the Underground into a Public-Private Partnership (PPP). Instead of a single public sector company, the Underground would be owned and managed by a public sector operator and three private sector infrastructure companies. Further analysis identified three factors critical to PPP success — appropriate asset investment and stewardship from the beginning; maintaining staff continuity and workplace attractiveness in transition; and initiating and maintaining effective collaboration across organizational boundaries. The difference between excellent and mediocre implementation in these respects was over £9 billion of “social benefit” over the next 30 years. LUL subsequently emphasized these areas throughout the tendering process and incorporated contract provisions to reduce risk in these areas.

**Educating Potential Bidders about the Underground**

Bidders had five months to prepare bids. LUL provided a huge amount of information, including asset registers, headcount data and financial projections. But LUL believed bidders would struggle to see “the big picture” and fully grasp the three critical aspects of PPP implementation in this limited time. LUL therefore gave bidders papers with model analysis tying the three critical implementation aspects to infrastructure company financial performance, documentation of model structure and assumptions to explain “how the Underground works,” and the model itself so bidders could simulate key dynamics and test different strategies for themselves.

**Enhancing LUL’s Bid Evaluation Process**

LUL had eight weeks to evaluate initial bids and select preferred bidders. Each bid was simulated with the model as a separate scenario as shown below.
This enhanced LUL’s bid evaluation in three ways. First, it provided a framework to integrate LUL expert review of bid detail into a coherent strategic view, making these reviews more valuable, and detecting bid inconsistencies. Second, “implicit” bid assumptions (assumptions not stated explicitly but necessarily true for internal consistency) were quantified, allowing LUL to judge reasonableness and to query bidders. Third, by simulating realistically likely system performance for each bid (and combination of bids) under different conditions, LUL could assess relative attractiveness of the bids on a risk-adjusted, “apples-to-apples” basis. ✦
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