

**COURSE MATERIAL 60**

COMMENTS

REPORTS

RESEARCH REPORTS

Kaisa Sorsa (ed.)

**PROACTIVE MANAGEMENT  
AND PROACTIVE BUSINESS  
LAW**  
A Handbook



**TURUN AMMATTIKORKEAKOULU**  
TURKU UNIVERSITY OF APPLIED SCIENCES

**COURSE MATERIAL 66**

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# PROACTIVE MANAGEMENT AND PROACTIVE BUSINESS LAW

A Handbook



TURUN AMMATTIKORKEAKOULU  
TURKU UNIVERSITY OF APPLIED SCIENCES



Education and Culture DG

Lifelong Learning Programme

The PAM PAL Erasmus Curriculum Development project has been funded with support from the European Commission. This publication reflects only the views of the authors, and the Commission cannot be held responsible for any use which may be made of the information contained therein.

COURSE MATERIAL FROM TURKU UNIVERSITY OF APPLIED SCIENCES 66

Turku University of Applied Sciences  
Turku 2011

ISBN 978-952-216-244-1 (printed)

ISSN 1457-7933 (printed)

Printed by: Tampereen Yliopistopaino Oy – Juvenes Print, Tampere 2011

ISBN 978-952-216-245-8 (pdf)

ISSN 1796-9972 (electronic)

Distribution: <http://loki.turkuamk.fi>



# ACKNOWLEDGEMENTS

Books happen in real life and in real places, and that time and those places are filled with people who aid your work in a number of ways. This book is an outcome of a two-year Erasmus Curriculum Development project *Proactive Management and Proactive Business Law (PAM PAL)*; therefore it owes to a number of contributors. It is not possible to single out and thank each and every one by name, but they will know who they are and know that we are grateful to all of them.

We, first of all, wish to thank the representatives and collaborators of the partner institutions of the PAM PAL project most of whom are also authors of this book.

The project and this book have benefited in a number of ways of the contribution and expertise on both law and language of Dr. Tarja Salmi-Tolonen LL.D., Phil.lic. of the University of Turku. We wish to express our thanks to her.

No curriculum development or research project is possible without a competent administration staff. We were extremely lucky to have had Ms Anu Härkönen M.A. of the Turku University of Applied Sciences (TUAS) appointed as an administrative officer to our PAM PAL project. From the preparation of the proposal and the very first meeting where she explained how we were expected to report our work and financial details at the end of each quarter to collecting data for the mid-term and final auditing reports, she and her contribution proved to be invaluable. We, a group of unruly academics, did not always make her work easy, but she always carried out her duties while maintaining her cheerful disposition. She deserves our whole hearted thanks.

We would not have managed without a lot of practical help from our colleagues. We want to thank Dr Javier Lete LL.D. of the University of Santiago de Compostela and Mr Casper Wissink from Ferens Legal who taught on the piloting courses, as well as Dr. Ana Lopaz and Prof. Dolores Salazar from the FLORIDA Centre de Formacio, Ms Krista Finstad-Milion PhD. from the ICN Business School and Mr Ari Jolkkonen Ed.lic. from TUAS for their help. We are also grateful to Ms Helena Haapio LL.M. of Lexpert Ltd. who shared her interests and lent us her expertise during the proposal and initiation phases of the project. We would also like to thank R&D Manager Dr Tony Wahlroos

from TUAS for helping with funding issues. We wish to extend our warmest thanks to Ms Niina Punelpuro from TUAS and the student assistants Mr Timo Juhala, Ms Riitta-Liisa Rantanen, Ms Noora Sirén, Ms Sini Tanskanen and Ms Minna Vahter-Kojo for their technical assistance during the project.

We are grateful to all the partner institutions for allowing the course modules to be piloted as part of their teaching programme, for their financial and administrative support and for their hosting the project meetings and their generous hospitality. We also want to thank all students who attended the courses for their feedback and help in developing the materials further.

Without the financial help of the European Commission this project would never have been completed and this book published; therefore we wish to thank the Commission. We also want to thank the editorial board of TUAS for their support in the editing process.

1.12.2011

*Kaisa Sorsa*

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# I INTRODUCTION

*Kaisa Sorsa*



# I BACKGROUND TO THE PROJECT

The aims of the *Proactive Management and Proactive Business Law* (PAM PAL) project are two-fold: firstly, to develop core curricula and teaching modules on proactive management and proactive business law at the bachelor's and master's levels, and secondly, to develop further the contents of the concept of proactive law. The project is a continuum from a research and development project entitled *Corporate Contracting Capabilities* conducted in Finland in 2006–2009<sup>1</sup>. One of the findings of the contracting capabilities research project was that organizations need, in addition to proactive contracting competences (Sorsa and Salmi-Tolonen 2006; Sorsa 2009b, 128–147; Salmi-Tolonen 2008, 1–17), also to expand their knowledge (Salmi-Tolonen 2006, 83–92; Sorsa 2006, 93–100; Pohjonen 2006, 101–109) and skills concerning business ethical issues (Sorsa 2008a and 2008b) and law in pursuing opportunities for value creation in today's globalized economy (Sorsa 2008c).

The knowledge gap between business needs and curricula at least at the Finnish higher education institutes teaching business and law was evident. The European Union Life Long Learning, Erasmus Curriculum Development Programme and the funding allocated by the European Commission provided an opportunity to start the project in October 2009. The purpose was to generate and develop new curricula and materials for teaching the course modules included in them and to develop the contents of the proactive law concept further. The project was completed in December 2011.

The outcomes of the project are the core curricula consisting of course modules of 24 credits (ECTS) in extent, course reading and teaching materials, academic articles and seminars for the local business companies and researchers. Three course modules on the following topics were designed and piloted: 1) Proactive

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<sup>1</sup> The project was funded by the National Technology Agency of Finland (Tekes, Liito) and the Academy of Finland (Liike 2). Kaisa Sorsa and Tarja Salmi-Tolonen conducted research in the project. Sorsa was the project manager for the sub-project of Turku University of Applied Sciences. Soili Nystén-Haarala was the project manager for the whole project.

Law and the Prevention and Resolution of Disputes, 2) Proactive Contracting and Risk Management and 3) Proactive Management and Business Ethics.

All the partners of the project consortium are institutions of higher education. There are eight partner institutions which represent both business schools and faculties of law at science universities and universities of applied sciences (both undergraduate and graduate schools). One of the institutions is a higher education centre offering postgraduate and university studies, vocational training, secondary education, and continuous, occupational and language training. One partner is a small law firm. The lead partner responsible for the project administration is the Turku University of Applied Sciences. The other seven partners represent both the Southern and Central European countries. The partner institutions are:

- Turku University of Applied Sciences (FI)
- Hogeschool Utrecht (NL)
- Florida Centre de Formacia (ES)
- University of Aarhus (DE)
- FerensLegal (NL)
- ICN Business School (FR)
- Universidade de Santiago de Compostela (ES)
- University of Turku (FI).



## 2 THE PURPOSE OF THE HANDBOOK

In addition to the basic knowledge of business and law, future managers need knowledge, tools and skills essential for today's working life, such as those needed for taking an active role in the development of law, proactive management skills and proactive approaches to contracting and dispute resolution.<sup>2</sup> It is not enough to focus on company level issues only. Future business leaders need to cope with the global business environment and global value chains even when they are doing business in only one country. Competences required for taking part in private and public law making need to be developed: for instance, agreeing on new policies, codes of conduct and implementing new management systems and processes. There is also a need to focus sharply on how to deal with the practical problems that are now being stirred up by the ethical debate (Raisner 1997).

Taking into account this new global business environment, the concept of proactive law is even more valuable than before. Future orientation is seen as a success factor for European companies both in legal and business issues (Sorsa 2011a).

The need for this kind of learning and teaching material as well as curriculum development has arisen from the fact that the business leaders in the globalized world need new kinds of competences. Work becomes more dynamic and decentralized – so does the legal environment where business is conducted. There is also a host of new social and environmental issues and trends in the external business environment that have an impact on companies, whether in terms of risks or opportunities, or both.

This handbook is meant to be used as a course reader and text book. Our guiding principle in writing this book has been that there is a group of students of different disciplines studying the topic in an integrated group. The rationale behind this principle is that in organizations the traditional

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2 Developing the Global Leader of Tomorrow, draft report 2008. 1st Global Forum for Responsible Management Education (United Nations, New York) and 21st Century Skills, Education & Competitiveness. A Resource and Policy Guide. Partnership for 21st Century Skills.

compartmentalization into different expert groups (legal, sales, technical etc.) has to give way to more flexible constellations in order to meet the current economic and business needs better. It follows from these hypotheses that the different background knowledge of the students has to be taken into consideration (Van Dorp 2011, 4). Therefore it is necessary to explain a number of basic concepts of both business and law from the proactive perspective.

The handbook gives basic knowledge of proactive management and proactive business law as it is currently understood. The materials can also function as a source of innovation because the concept of proactive law is dynamic and developing. We therefore encourage all readers and users to use this material in a creative way.

### 3 PROACTIVE LAW AND ITS MANY PERSPECTIVES

In order to make the material at hand understandable as a whole, some clarification is in order. Proactive law is a developing concept and therefore there is no total unanimity among researchers and practitioners of its contents and meaning. The body of knowledge generated thus far can be divided into pragmatic and theoretical, or in research terms, inductive and deductive. The pragmatic part of the notion is developed mainly by practising lawyers and consultants based on their professional experience and as a rule published in professional journals. Theoretical studies have added new dimensions to the concept. Research with contested methods are conducted in several faculties, both law and economics and business, at science universities and published in academic research journals, edited works and monographs by academic researchers: Keskitalo (2000) has developed proactive contracting theory from contractual risk management perspective based on contract law, law and economics, and risk management literature; Salmi-Tolonen (2005; 2008) has developed the content of proactive law from the linguistic viewpoint; Tieva (2010) has analysed long-term partnerships and the role of proactive contracting as a management tool in the field of construction; Sorsa (2011a) has developed the content of proactive law concept broadening the analysis towards regulatory research and value chain management.

These earlier research findings and the further developments conducted during this curriculum development process enable us to make some conceptual clarifications on proactive law and the proactive approach to law.

#### 3.1 A PROACTIVE APPROACH TO LAW

The content of proactive law depends on *from whose or from which* perspective it is examined. When the writers highlight *the practical elements in proactive law* it is more reasonable to call it *a proactive approach to law*. The focus may be

on contracting practitioners' or business professional's relation to law or how companies use the law as a source of competitive advantage. The proactive approach to law can also be applied to legal professionals' (lawyers, legal counsels' or advocates') work. Then the lawyers' relationship with their clients and the services the lawyers offer to their clients are in focus (proactive lawyering).

The public law maker's perspective is also relevant here. When this is the case then the analytical question is how private actors can better be involved in the law making processes. In many cases public law makers leave room for private actors and even try to encourage them to take more responsibility of public issues. In this context, public law makers also use a proactive approach. All these perspectives the future business leaders need to comprehend and take into consideration.

Understanding the relational issues is a prerequisite for the development of proactive law. Comprehending the issues is needed in order to understand the feasibility of different legal tools in business.

## 3.2 PROACTIVE LAW

The concept of proactive law sets legal structures, tools (rules, contracts), processes and activities in focus. In this project, proactive law is by definition “a comprehensive concept concerning civil and commercial matters which refers to any regulation measure/activity, undertaken by public or private actors, as well as its methods, instruments, and results, whose purpose is by imposing duties, conferring rights and creating competences to enable and empower individuals concerned or private or public bodies in achieving their commonly defined goals. In practice, the forms this concept takes are rules, practices and/or processes” (Salmi-Tolonen 2011).

Rules and other regulatory measures can be enacted and developed also by private actors and not only by public law makers. Those measures are aimed at achieving certain positive outcomes. As the final outcome of regulation measures in the core of the proactive law is the implementing activities that are crucial for the success of proactive law. In other words, the empowerment of individuals in the standard setting, implementation and monitoring phases in order to achieve a set of goals is the core element of proactive law. There is a rich variety of implementation activities developed in the field of private regulation

both by individual companies as well as non-governmental-organizations. In many cases the proactive processes are highlighted and emphasized instead of the reactive processes (e.g. proactive vs. reactive monitoring processes).

The European Social and Economic Committee Opinion “The proactive law approach: A step forward to better regulation” provides a backdrop for the work of our consortium. It emphasizes the importance of new kinds of regulatory methods and attitudes on the law makers’ part, in order to make the international business environment more manageable.

Proactive law in, for instance, proactive contracting is considered an enabling tool. The enabling element refers to the accomplishment of the desired goals of the actors. Understanding the feasibility of proactive law necessitates understanding of the business context where the rules are applied. The enabling aspects bring on the agenda the evaluation issues which are relevant both from the public law and the private law perspectives as well as for proactive contracting. Enabling by using proactive law instead of traditional regulatory measures or traditional contracts, highlight the need for assessing the impacts of these new instruments (Lempert 2010 and 2011; Sorsa 2011a).

For examining government and private sector systems that seem complex and difficult to understand, evaluation is needed and different tools have been developed in order to measure their performance and turn those measures into clearly defined remedies. For students and scholars in management, evaluation aspects offer an additional framework for looking at management accountability and oversight systems. (Lempert 2010, 60)

Some concrete examples in the proactive law section and proactive contracting section will demonstrate the feasibility of proactive law and proactive contracting as a governance tool in dynamic and complex civil and commercial matters. In global business, many dynamic regulatory systems have been developed by proactive people and groups of people. These examples also demonstrate that the systems and schemes as such can be self-correcting and dynamic.

## 4 PROACTIVE MANAGEMENT AND PROACTIVE BUSINESS LAW COMPETENCES

The global leaders of tomorrow need to understand the changing nature of the business environment, to have an ability to lead facing complexity and uncertainty and to have an ability to understand the actors in the extended business environment and political landscape. They also need an ability to engage in and build effective relationships with new types of external partners, such as competitors, regulators, non-governmental organizations or local communities (see e.g. Van Nieuwal 2011). The mind-set in which our current leaders are raised and educated does not encourage productive engagement with partners outside the organization. The global leaders of tomorrow need to be able to identify key stakeholders that have an influence on the organization, and to understand the impact of their organization on these stakeholders, either positive or negative, and the impact of these stakeholders on their organization (Sorsa 2009d).

Employers' and managers' knowledge and skills are commonly considered to be the key success factors for economic development and social well-being. Education, again, is the vehicle for enhancing human capital. The aim of the project is to develop the core curriculum and teaching materials based on the proactive management and proactive business law competences. During the two-year project four general proactiveness competences were developed together with the project partners. A detailed and profound description can be found in the teacher's guide (Sorsa 2011c).

The concept of proactive behaviour at the organizational level has been the focus of research of authors such as Bateman and Crant (1999), but for the purposes of the PAM PAL project and its outcomes, it was necessary to define the concept of proactiveness in relation to proactive law. It describes the proactive profile understood as a set of professional achievements that a

person shows when faced with different work situations within his or her own occupational area – once the training process has been completed.

Pro-action involves creating change, not merely anticipating it. It does not only involve important attributes such as flexibility and adaptability towards an uncertain future. To be proactive is to take the initiative in improving business. Professionals who are proactive engage in the following forms of behaviour (Bateman & Crant 1999).

1. Scan for change opportunities.
2. Set effective, change-oriented goals. Proactive behaviour is focused on accomplishments, but particularly on accomplishments with real impact.
3. Anticipate and prevent problems.
4. Do different things, or do things differently.
5. Take action. Much has been written about the need for an action orientation, including Peters and Waterman's "bias for action" (1982).
6. Persevere. Proactive people persist in their efforts. They do not back off from the obstacles, they do not take no for an answer, they do not settle for less, and they are not satisfied with being able to say after a defeat, "Well, at least I tried."
7. Achieve results. Implicit in the comments above is a clear result orientation. Change must not merely be thought of or attempted, but achieved.

Thus, to develop a proactive behaviour, an individual needs to have the big four proactive competences, which are described in detail below.

*Creative thinking:*

An ability to develop new ideas and concepts in order to respond to needs, problems or challenges, by means of an original and previously non-existing result.

*Cross-professional communication and networking:*



An ability to act autonomously as well as to co-operate, communicate and solve disputes in interdisciplinary teams or diverse professional settings.

*Multidisciplinary analysis:*

An ability to identify the key factors for success and opportunities based on the necessary scientific analysis, including interdisciplinary analysis and best business practice analysis.

*Outcome orientation:*

An ability to establish goals and make appropriate and sustainable decisions in order to implement the necessary strategies which secure success and new opportunities.

These competences are common for all three teaching modules. In the CCC project mentioned above, three individual competences and one group of organizational competences were already developed for proactive contracting purposes. These competences are: *contracting content related competences, process related competences and relational competences*. The aim of the project has also been to develop different learning activities and tools for and with students in order to cultivate the students' skills on these competence areas.

# 5 THE STRUCTURE OF THE HANDBOOK

The handbook contains course reading for the three modules which emphasize different aspects of the topic. The purpose of this handbook is to provide reading for the students participating in the three PAM PAL courses. The scope of the reading material alone is estimated to extend to 15 credits (ECTS). Additional material will be included in the teacher's guide (Sorsa 2011c), for the case studies and extra exercises in order to illustrate the ideas expressed, to aid learning and in order to organize seminars or workshops (3 ECTS each) after finishing one or more course modules.

All courses can stand alone, and be taught independently from each other. The three modules are:

- 1) Development of Proactive Law – the Prevention and Resolution of Disputes
- 2) Proactive Contracting and Risk Management
- 3) Proactive Management and Business Ethics.

The handbook is designed in such a way that it enables teachers and students to use all the materials, in case they follow the entire module (15 ECTS), or one of the three courses separately, or parts of the material for different combinations. These options are available because there are a number of differences set to the curriculum requirements in different educational institutions.

The PAM PAL curriculum brings a totally new and innovative aspect to the mainstream legal education and to business studies showing how law affects the firm's competitive environment and value chain. It should be noted that both management and business law are included in all the teaching packages.

## 5.1 PROACTIVE LAW AND THE PREVENTION AND RESOLUTION OF DISPUTES

The text for this module is presented in two parts: Part I: Proactive law in public and private regulation and Part II: Proactive approaches to law. The first part concentrates on the legal structures and processes which are the outcome of proactive behaviour in the networked business environment. Law is seen here as an evolving and developing phenomenon, which is created in dialogue between the different actors of the society (Sorsa 2011a).

The second part focuses on the proactive approach to law by different professional groups. Law and the legal environment are in this case seen as “given” and the proactive approach to legal knowledge and different stakeholders can improve the company’s competitiveness.

The objective of the studies in this package *Proactive Law and Prevention and Resolution of Disputes* is raising the participants’ theoretical and practical skills about dynamic legal systems and in using the law as a governance tool. It presupposes proactive thinking and proactive behaviour of the people involved. These skills and knowledge will turn into students’ willingness and ability to take action, not only at the company level but also in the broader stakeholder networks. They will be “change makers” and “frontrunners” as empowered business managers, consumers or as active members of the civil society.

The focus of the first part of the module will be on public and private legal structures and processes explaining how these systems can be proactive and dynamic. The idea is to illustrate how networking business people have already developed new and innovative solutions for the global environmental and social problems using self and private regulation schemes as a governance tool. The focus will at first be on the contents of these different rule systems, on trying to understand their underlying goal (proactive law’s content perspective); secondly, the focus will turn to the proactive law’s process perspective (Sorsa 2010).

As in the global decentralized economy standards are more and more created outside the nation state, the future managers need to understand the structures of the new economy. The self and private regulation part of the course focuses on some world-widely known private regulation schemes in order to concretize proactive law at the rules and structures level. At the same time these examples will demonstrate why it is necessary for a company to take into account the

broader stakeholder viewpoint instead of taking care only of its suppliers and customers. This part of the module highlights the “private law maker” viewpoint instead of the passive “law taker” point of view. (Sorsa 2009c).

Three examples will demonstrate how these private regulatory systems are *created, monitored and implemented* and what the role of a single company in that process will be. The purpose of this part is to throw light on the need to see the company as an active participant in industrial, multi-stakeholder or consumer networks as these new constituencies play a key role in the international value chain management.

*The prevention and resolution of disputes* chapter describes the different public and private conflict and dispute resolution methods and processes available, which are introduced to avoid judicial resolution of conflicts (litigation) and to facilitate smooth business processes. Dispute resolution might be the first application in which proactive law has been developing. Public law makers have found that it is to the advantage of the public authorities to encourage people to solve their disputes early, before they have a full conflict in their hands. In the proactive law module, the purpose is to enhance the students’ knowledge and develop their skills in preventing disputes before they have even been arisen or early enough to stop the differences developing into full-fledged conflicts and to promote best practices.

*The proactive approaches to law* part develops the students’ competences in using legal knowledge for managing risks and opportunities, working with different professionals at the company level and using legal knowledge as a source of competitive advantage for a company. The section starts with a short description of the history of the proactive approach to law. This part of the module can in some realizations use a business game as a learning tool in order to exercise the students’ skills in decision making and strategic thinking. Exercises and suggestions are recorded in the teacher’s guide (Sorsa 2011c). This part also considers the proactive approach to law from different professionals’ perspective.

## 5.2 PROACTIVE CONTRACTING AND RISK MANAGEMENT

The focus of this course is on the contracting. The key question is how contracting can be used as an enabling and a risk management tool in different contractual situations. As the key principle of contracting is the freedom to

contract; this means that parties to a contract need to understand on the one hand the legal framework for contracting, and on the other hand, how they can draft the contract clauses so that they best reflect the commonly expressed and desired goals. From this perspective, contracting parties can be rule takers applying mostly the applicable legislation and principles to their contract or rule makers designing the content of their contract by themselves. The theory of risk management guides the development of contract clauses and contracting methods.

When broadening the perspective from single contracting parties to the management of the whole value chain, new management tools become relevant. Quality standards, process standards, codes of conduct and other self and private regulation tools are needed in promoting good business practices in the value chain. Examples of different self-regulation systems will throw light on how these systems help prevent, for instance, environmental risks, social risks, product quality risks or food safety risks in global value chains. From this point of view, the proactive approach emphasizes the need to understand law as an outcome of the decentralized legal order. Private regulation is created, enacted and monitored by business people and non-governmental-organizations. All the actors of the value chain are connected and linked together by contracts and by relational ties in one way or another.

The Proactive Contracting module encompasses also *a managerial part*. Contract processes, contractual tools and methods need to be managed at the company level. The contract management part of the module concentrates on the development of students' managerial competences in proactive contracting. A Maturity Model will be presented as one possible management tool (Sorsa and Salmi-Tolonen 2009; Sorsa 2009a).

### 5.3 PROACTIVE MANAGEMENT AND BUSINESS ETHICS

In the proactive management and business ethics module, the aim is twofold. On the one hand, the module aims at providing future professionals with the necessary background knowledge and skills which enable them to become proactive members of the business community and contribute to value creation. Proactiveness, as an organizational attitude, can be described as a permanent identification of opportunities to which an adequate response is given. The module focuses on these two key elements of business management:

- Strategic Management
- Innovation Management

Throughout this section, students will become familiar with business strategy, analysis and strategy formulation, as well as innovation and opportunity management. On the other hand, this section deals with the development of initiative taking and decision making skills, creativity, leadership, problem solving and team management skills. All these skills are needed for the success of business organizations and increasing the efficiency of their management. This module considers proactiveness at the company level and from a managerial perspective.

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## II PROACTIVE BUSINESS LAW AND THE PREVENTION AND RESOLUTION OF DISPUTES



# I INTRODUCTION

*Tarja Salmi-Tolonen*

Over time, the meanings attributed to concepts such as justice and law change, even if the words referring to them remain unchanged. As is well known, different disciplines offer different perspectives for examining the world, and conceptual systems can be changed. Traditionally law has been understood as a body of rules made by the national legislator. This is no longer true. The trend today is towards a more pluralistic view that includes not only rules made by state legislatures but also a new body of rules, practices and processes by private actors, such as companies, NGOs, or epistemic communities, either exercising autonomous regulatory power or implementing delegated power conferred by international law or national legislation (see Cafaggi 2009 and 2011). This development accentuates the enabling and empowering quality of law, thus also emphasising its future-orientation and pre-emptiveness. This reflects of course the reallocation of regulatory power and the changes in the world.

Along with this development towards a more pluralistic view of legislation and the reallocation of legislative powers, judicial practice has also diversified: private mechanisms of dispute resolution have been established. International commercial arbitration is an alternative to national jurisdiction, in which the states, their coercive judicial measures and public judicial practices are considered the default. From this point of view arbitration and other alternative dispute resolution practices entail the privatisation of public practices and transferring legal practice – conflict resolution – to private commercial actors.

The growing number of international trade disputes has prompted the development of alternative instruments for settling such disputes. In Europe, as in the rest of the world, arbitration has become more and more common as a mechanism for the settling of commercial disputes. In conflicts concerning cross-border exchanges, arbitration is regarded as an economical and effective alternative to litigation (Salmi-Tolonen 2011a).

*Law* is a polysemic word – it has many meanings. It can first of all refer to a discipline studied at universities and law schools with the aim of educating legal professionals by providing them a systematic view to law in all its forms and domains. It can be understood more widely as the sources of law: legal principles, customary law, case law and black letter law. Law can also be understood more narrowly as a body of norms or legal order, in other words, a set of rules expressing the will of the legislator in a statute book. Law can also refer to an Act of Parliament. Today, private regulation set by private bodies and standard setters can be included. Law can also have a wider reference and comprise all these and the system of courts and legal practice and also the legal profession and their activities. It is therefore a notion used for many purposes but we usually have no difficulty in understanding whether a wider or more restricted meaning is in question.

In the pages below, *law* has got a qualifier *proactive* which indicates that what will be said is something more than *law* alone as a notion would be. *Proactive* complements law; therefore it cannot stand alone, but it adds something to the well-known traditional or more recent views on law. Even in the short history of this concept a change can be seen: it first referred exclusively to an approach to practising law but more recently also to making law. The special reference here is the context of world-wide business. By definition *proactive law* is a comprehensive concept concerning civil matters. It refers to any regulation measure/activity, public or private, as well as its methods, instruments, results and actors, whose purpose is by imposing duties, conferring rights and creating competences enable and empower concerned individuals or private or public bodies in achieving their commonly defined (their) goals. In practice, the forms this concept takes are rules, practices and/or processes. (Salmi-Tolonen 2011b, see glossary in this volume)

## 2 THE STRUCTURE OF THE SECTION

*Kaisa Sorsa*

This Section is divided into two Parts. In Part I, the focus will be on the regulatory system level – both public and private. The rationale for this is that global business is increasingly driven and governed by dynamically changing private regulation. The phenomenon is seen especially in the proliferation of private regulation in the context of corporate social responsibility. Part II will be focused on the behavioural aspects of the professional actors in global economy – legal professionals and business professionals. The division into these themes also serves educational purposes because – depending on the audience – it allows the educators to place emphasis on the aspects they consider necessary. The premise for developing this material has been that proactive business law is a multi-disciplinary topic and that there will be a multi-disciplinary group of students studying together, but the possibility of teaching other kinds of groups will naturally not be excluded.

In the first sub-section, the content and process perspectives of proactive law will be described using self and private regulation systems to illustrate these perspectives. Seen from the legal point of view, these systems are not very familiar to most students even though they are the order of the day.

In the second half of the first sub-section, methods for settling commercial conflicts and dispute resolution mechanisms – both public and private – will be discussed. This second example of regulation practices will show for its part that public regulation has also shifted towards proactive law.

The focus in the second sub-section will be on the behavioural aspects of proactive law. At the beginning of the section the proactive approach to law and its history and development will be explained. In this part, mainly the company level view is taken instead of that of the system level. It is also made visible what the proactive approach to law means in practice for the different professional groups. This sub-section is also methodically oriented towards paving the way for using a business game as a learning tool.

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PART I

PROACTIVE LAW IN PRIVATE AND  
PUBLIC REGULATION



# PROACTIVE LAW AND PUBLIC AND PRIVATE REGULATION

*Kaisa Sorsa*

Proactive law is enabling, empowering and user-friendly, dynamic law aimed at obstructing unwanted phenomena and promoting desired goals. Enabling and empowering refer to civil society actors both law makers – public and private – and law takers – citizens, civil society members, organizations. User-friendliness and being dynamic, again, refer to mechanisms (rules and processes) and the prevention of undesired outcomes and the promotion of the goals set by the actors in civil society (see Figure 3, Sorsa 2011a, 141).

The aim of this chapter is to explain the concept of proactive law. This will be done with the help of some well-known, global self and private regulation examples. The currently topical discussion of corporate social responsibility provides a context for reviewing the role of private regulation in the concept of proactive law<sup>3</sup>. The reason for this choice is that it is in this context the companies, non-governmental-organizations and civil society actors create rules and monitoring systems for transnational business. Co-operation in standard setting and monitoring is done in *regulatory networks* although the company level should not be forgotten either because the implementation of these standards naturally require company involvement. First, however, how and why the proliferation of private rulemaking is taking place at the global and European levels will be discussed. Explanations can be found in the future oriented business mind, active non-governmental-organizations and the proactive approach to law by public law makers (Sorsa 2011a, 86–133). We will begin with taking a look at the legal environment on the European Union level and the European Economic and Social Committee Opinion on the proactive approach to law (EESC Opinion 2009)<sup>4</sup>.

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3 See for a more profound analysis Sorsa 2010c where she compares and analyzes 42 different private regulation systems, Sorsa 2010c.

4 Opinion of the European Economic and Social Committee on ‘The proactive law approach: a further step towards better regulation at EU level’, Official Journal of European Union, July 28, 2009, at C 175/26, § 2.2, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:175:0026:0033:EN:PDF>.

## 1.1 FROM SINGLE LEVEL TO MULTI-LEVEL GOVERNANCE

The 1991 Treaty of Maastricht marked both political support to and the creation of legal space for the development of what is now usually known as *multi-level governance* in the European Union. The multi-level form of governance represents an approach which is less top-down and more bottom-up. The Treaty widened the door for a more flexible, differentiated and soft convergence of the European legislative and regulatory culture by making the choice of legal instruments more open and creating a scope for the use of alternative instruments such as self-regulation, private-regulation and co-regulation instruments. From the civil society actors' perspective and from a single company's viewpoint this change meant that non-governmental-organizations and company people need to appreciate their new active roles in the new legal environment as *private law makers* (Sorsa 2011a,141). In domains where the EU does not enjoy exclusive competence, the application of the subsidiarity principle is also contributing to the restrained attitude of the European legislator, only acting, if and insofar as the objectives of the proposed action cannot be achieved satisfactorily by the Member States and can better be achieved at the Union level because of their scale of effects. (Senden 2010, 1–2).

On the global level, states or groups of states act primarily through hard law and treaty-based intergovernmental organizations (IGOs) to control the conduct of economic actors (Figure 1). They use mandatory legal rules with monitoring and coercive enforcement which is, however, outdated and ill-suited for the needs of the new globalized economy (Abbot & Snidal 2009; Sorsa 2009c). Since 1970, attempts to regulate the activities of corporations have significantly changed in the context of an increasing economic integration. International regulative approaches have been complemented and in many cases substituted by transnational institutions. Private regulation, both national and transnational, increases at high speed. (Pattberg 2006, 1; Sorsa 2010b).

LEVELS	ACTORS	OUTCOMES POLICY/STRATEGY	PROCESSES
TRANSNATIONAL	IGOs: WTO OECD, ILO	Treaties, conventions, Int.gov.agreements	Standard setting
EU/NATIONAL	Public law making institutions	Laws, regulations, guidelines	↓ Implemen- tation
PRIVATE REG.	ICC, trade association Standardization org.	Standards, self-reg. schemes, codes of conduct, codes of ethics, GTCs	↓ Monitoring
CIVIL SOCIETY	NGOs, CSOs	networks	
VALUE CHAIN	Company, consumers competitors	strategies, operative tools	CM – HRmgt CSRmgt Qmgt
CONTRACTING	Contracting parties		

**FIGURE 1.** *Multi-level regulation.*

We live in a world where national and private law compete and co-operate with the ever growing set of national and transnational private regulation. Transnational private regulation differs from international regulation (hard law) primarily because rule making is not based on states’ legislation. It is, rather, centred round private actors, interacting with international organizations<sup>5</sup> (IO) and intergovernmental organizations (IGO<sup>6</sup>) (Cafaggi 2011, 21). A key concept in transnational rule-setting activities is sustainability (Kalfagianni & Pattperg 2011, 1–2) which can be found in our three examples below.

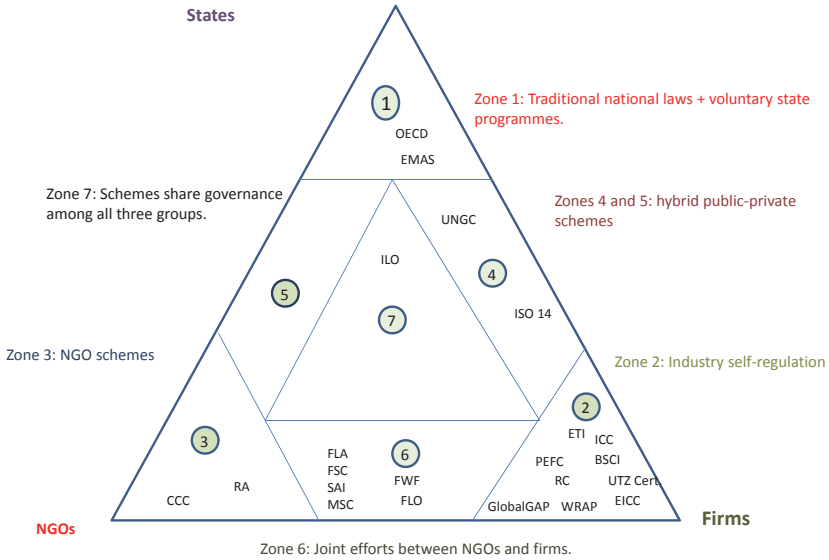
The past twenty years have seen an increasing array of private actors engaged in “steering tasks that were classically in the sphere of states” (Sieber 2010, 13; Sorsa 2011a). This has meant significant changes in the institutions and processes of the global business regulation in most OECD member states. Non-state actors, both profit and non-profit, have gained steering capacity through the formation, dissemination, monitoring and enforcement of norms, rules and standards. These phenomena may be conceptualized as sites of private governance (Figure 2).

Global business regulation can be loosely defined as the limits imposed on the behaviour of economic actors, expressed in rules and standards. Cafaggi (2011, 20–21) refers to the same phenomenon with the concept “Transnational Private

5 E.g. The International Chamber of Commerce, Greenpeace, the WWF, Amnesty International.

6 The most well-known international organizations are the World Trade Organization and the International Labour Organization.

Regulation” which constitutes “a new body of rules, practices and processes, created by private actors, firms, NGOs, independent experts like technical standard-setters and epistemic communities”. They exercise autonomous regulatory power or implement delegated power, conferred by international law or by national law (Cafaggi 2009, 31).



**FIGURE 2.** *Different networks for private and public regulation.*

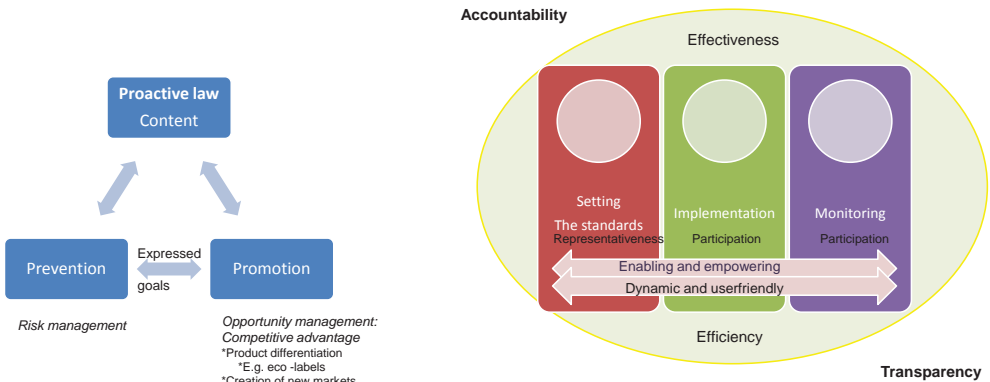
The evolving structures of the global production – multinational enterprises and global value chains – pose major challenges to conventional regulation and the legal infrastructure in general. With the legal infrastructure we mean the legal resources available to individuals, organizations, and regulators to help govern relationships. A trans-national non-state power has assumed greater significance at the cost of the nation state (Scott 2010, 1). Self-regulation and broadly speaking private regulation<sup>7</sup> has emerged to certify corporate social and environmental performance in the global business environment (Hadfield 2010, 4).

<sup>7</sup> Vogel uses the notion civil business regulation, Vogel 2009, 2. The term civil regulation comes from Simon Zadek, *The Civil Corporation* London; Earthscan, 2001. See also Sorsa 2008c.

## 1.2 PROACTIVE LAW AS SYSTEM LEVEL INNOVATION

Private supply chain certification systems have emerged as instruments to assure responsible and sustainable practices at the production side in developing countries (Vermeulen 2010; Vermeulen et al. 2010). These commercial policies in the private sector are becoming a far more important factor in the spread of some environmental requirements than, for example, any formal environmental or trade policies (UNEP 2005). This is true especially in the context of increased sourcing of consumer goods from the developing countries to the Western markets. These initiatives have been taken by businesses and NGOs in the regulatory vacuum referring to the European governments' ineffective addressing of the unsustainable practices of the suppliers in the developing countries (Vermeulen 2010; Roome 2004). Private regulation solutions to global problems can be described as systemic innovations, which are guiding the development into a more sustainable direction in the global economy (Sorsa 2011b).

Systemic innovation is a set of interventions that shift a system to a sustainable path ([www.forumforthefuture.org](http://www.forumforthefuture.org)). Systemic innovations require significant changes to other components of the system (Teece 1996). As dynamics pervade our society, we need to deal with change and prepare current and next generations. (Van Dorp 2011, 7). Roome (2004, 277) describes this phenomenon arguing that business is seen to move from a reactive response to environmental concerns expressed through regulation, toward a more proactive approach, based on the search for synergies between competitiveness and environmental performance.



**FIGURE 3.** Proactive law: content and process related factors (Sorsa 2011a).

In the private regulation life cycle, we can distinguish five different stages: standard-setting, adoption, implementation, conformity assessment and enforcement. The examples explained in this chapter represent the governance, monitoring and enforcement systems in order to concretize the content of the proactive law concept from its content, process and time related perspectives. For the teaching of proactive law this means compiling knowledge related to the relevant actors of global and local businesses and networks where company people should be involved and active. Structures, rules and procedures of the legal environment have changed and this forces business people to decide which self or private regulation systems they want to participate in or have *de facto* to participate. Do they want to be the “rule takers” or the “rule makers” in this environment? According to Deloitte’s *Global Powers of the Consumer Products Industry 2011* report, the key themes that will characterize the next few years “will be the need to be proactive in shaping regulation” (Deloitte 2011, 7).

In order to make a strategic decision at the company level about the company’s relationship to different standards, a common understanding is needed on how to assess these different private regulation systems and how they fit into the company strategy. The capability to evaluate requires communication between different professionals, such as marketing managers, quality managers, corporate social responsibility managers, human resource managers, contract managers and lawyers. Communication is also essential between the company and research society networks (Hautamäki 2010, 108–128).

The context and examples in this chapter will be of the food industry and the topics will be related to food safety and corporate social responsibility in global food value chains.<sup>8</sup> The chapter begins with an introduction to the decentralized legal environment.

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8 See Sorsa 2008a, 139–149.



### 1.3 CASE: IMPORTING FOODSTUFFS TO THE EU

The world economy is increasingly organized in cross-border networks and value chains largely beyond the control of public actors<sup>9</sup>. European law is not extra-territorial and thus cannot be said to apply directly to any country or business outside the EU. However, the EU importers and retailers must comply with the law even though they are doing business with companies outside the EU. It is not enough that the company people take care of the compliance with law in their own company because they are liable for the conduct of their importers' actions as well.

Food safety has become the top priority for governments and the private sector in Europe. The development of both public and private food safety standards has been driven by the numerous food scandals that occurred during 1995–2005 (Willems, Roth & Roekel 2005). The European food safety regime prohibits food that is unsafe. The product will be deemed to be safe, if it has been produced in compliance with the specific provisions on food safety. Many of the foodstuffs, however, are imported to the EU and produced under the laws of an exporting country which may differ from that of the EU (Broberg 2009, 6).

The European food safety control system consists of three layers. The primary control is carried out by the individual food business since it is required to verify and document that it complies with the food safety rules<sup>10</sup>. There is a distinction between animal origin and non-animal origin products. The former are considered to represent the greatest risk and are therefore subject to stricter control than the products of non-animal origin. The animal origin food businesses must obtain approval and registration before exporting to the European Union.

In contrast, there is no requirement of pre-approval for food products of non-animal origin. This means that it is incumbent on the Community importer to verify that the third country food business meets the Community's food safety

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9 In contrast to economic organization in the era of 'embedded liberalism' (Ruggie 1982), where capital was predominantly national in terms of ownership and management and integrated into a historic social compromise, the current economic order is largely organized around transnational capital in terms of ownership, management, exchange, and relevant stakeholders such as shareholders, suppliers, and consumers. Transnational corporations have emerged as the new powerful actors in the era of globalization, largely unrestrained from public regulation. (Pattberg 2006, 2).

10 The secondary control is the responsibility of the national authorities. Member States must lay down rules on measures and penalties to sanction infringements of food law. As the third control layer the European Community has set up its own body to control that the Member State food safety authorities duly fill their obligations. This is known as the Food and Veterinary Office. Regulation 178/2002, *supra* note 8, Article 7(2).

requirements. (Broberg 2009, 5–6). Community food regime specifies legal minima as market requirements that the third country supplier must comply with in order to export food to the EU markets. Hence third country suppliers (growers, processors and exporters outside the EU) of different foodstuffs intended for the EU market must meet the specifications of Community food law, as these constitute a market entry requirement that will be asked for by any reputable EU import business (Willems et al. 2005).

The secondary control of food safety is carried out by the Member State authorities and the EU. They have the power to carry out control checks inside the EU in their own country but they do not have such power concerning food businesses situated in third countries.

Question: Imagine that you are doing business as a food processor in the EU. Under these circumstances the individual companies have real challenges – should they try to cope with this challenge alone or are there any other options?

## 1.4 PRIVATE ACTORS, GLOBAL CHALLENGES AND NEW SOLUTIONS

Private actors in the food value chain can be categorized as follows: the input industry and agriculture sectors, the processing sector, namely, manufacturing and packaging of food, and the retail sector, namely, distribution and selling (Figure 3). Especially the retail companies selling products to consumers have been struggling with food safety issues for a long time. The challenge related to food safety seemed to be too big to be met by a single company alone<sup>11</sup>. There was a need in food industry and in retail business to reassess the challenge from the global value chain viewpoint.

The share of the top ten global corporations in the global foodstuffs market is 28 per cent and the top five companies account for 18 per cent. The top 15 global supermarket companies represent more than 30 per cent of global sales. A trend that the global retailers and fast food chains are expanding is evidenced by data showing that the top 10 retail corporations have more than doubled their share of the global food retail market since the year 2001. The food processing sector seems not

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11 Food safety is one element of responsible business. See how responsible business can be integrated into company strategy by proactive management approach Sorsa 2008b, 151–162.

to have undergone the same trend. From the companies' perspective, the reason for this lies in the fact that the processing industry is not as close to customers as food retailers are and, thereby, is adjusting more slowly to their tastes. (Dalle Mulle & Ruppanner 2010,15). The ongoing changes in food supply chains have contributed to the modernization of food marketing in many developing countries, spurring agribusiness development and the establishment of modern food standards and regulations.

#### 1.4.1 Global challenges: corporate social responsibility

Under the circumstances, where the consumers demand safe food products and the public sector requires efficient methods to ensure food safety, the retail companies started to cooperate. The development trend of market structures partly explains why the retail sector has been very active in developing different private regulation systems according to the consumer demand (Liapis 2011, 15–17). Although the Community legislation represents the minima for market access, many of the larger retailers and some wholesalers require suppliers to demonstrate compliance with independently verifiable private standards. Sometimes they set the standard's criteria even higher than the legal minimum. A case in point is the Global Good Agricultural Practice (GLOBALG.A.P.) standard and also some other food industry standards (see e.g. Sorsa 2011a). They provide an effective way of verifying that suppliers have the necessary management and control systems in place (Sorsa 2011a, 107).

In practice, the EU importers, for instance, a procurement organization of a wholesale company (e.g. Finnish Inex Partners Ltd.), are responsible for ensuring that all foodstuffs imported into the EU comply with the requirements of Community food law. They must also be able to provide evidence of compliance when requested (Graffham 2006, 14; Willems et al. 2005, 12). These challenges have been reasons for the ever growing self and private regulation.

It is not only the food safety issues, however, which have been raised on the agenda. Consumers, financiers and public authorities have also demonstrated a growing interest towards environmental and social issues (Kotro et al. 2011, 26–31). All these topics are included in private standards which make it possible to use the standards also as a source of product differentiation (Sorsa 2009d, 49). For instance, the European fresh produce market is very diverse in terms of consumer preferences, structural dynamics and attention to the enforcement of food safety and other standards. Consumers in Europe

have become increasingly concerned about food safety and the ethical and environmental conditions under which food is produced and distributed. (Jaffee & Masakure 2005, 317). Food safety and sustainability issues have been developed into a “core competence” by the major market players whereby the bundle of skills and technologies required enable companies to provide a special, non-product-specific benefit to their consumers (Willems et al. 2005).

However, the market and regulatory context of this trade is changing fast in ways that are raising the bar for new entrants and putting new challenges and pressures on existing developing country suppliers. This is especially true in relation to supplying the fresh vegetable markets of the European Union. Recent food scares and related events over the past decade have shaken the trust that many European consumers have in the safety of their food and have raised concerns about the credibility and effectiveness of food safety regulatory systems.

Below we will give examples of managing food safety, environmental issues, and economic responsibility. The Good Agricultural Practices (GLOBALG.A.P) standard, the Fair Trade and the UTZ Certified schemes are given as examples of proactive law in the context of global food value chain management.

#### 1.4.2 New tools for global governance

Proactive law is done by, with and for the users of the law, individuals and businesses. The three examples below will illustrate how private regulation systems are accomplished by individuals, business and non-governmental organizations (NGOs). There are times when the legislature may best support valuable goals by refraining from regulating and – where appropriate – encouraging self-regulation and co-regulation. (EESC Proactive Law Opinion)

At times, the legislator may fail to regulate or it may have difficulties in gaining consensus, especially in transnational environments. In general, the Parliamentary legislature is slow, but the current changes in the business environment require fast responses. Private regulation is a more dynamic method and can respond to the changed circumstance faster. It might also be that the regulator does not have competence to regulate other country's production systems as is the case in the food safety example. These are some reasons for the emergence of self and private regulation systems (Sorsa 2009d,121–142). In the case of food safety, the EU legislature does not have

the competence to regulate the third country's production systems and the EU regulator has failed to secure food safety when using only hard law methods.

During the last few decades, the fields where standards play an increasingly pervasive role have turned out to be the technical, quality, safety, environmental and social specifications for products and processes (Wouters et al. 2009, 5). These standards guide producers in how to produce their goods, and provide information and assurance to consumers and business partners on what they purchase. (Sorsa 2010b; Kaivo-oja 2011).

During the 1990s, the number and scope of global private regulation began to expand significantly, especially in the field of corporate social responsibility. Private regulation defining standards for responsible business practices now exist for virtually every global line of industry and internationally traded commodity, including forestry, fisheries, chemicals, electronic equipment, apparel, rugs, foodstuffs (coffee, cocoa, palm oil, fruits, vegetables), toys, minerals and mining, energy and financial services – though formally the standards govern only a portion of these products or sectors (Sorsa 2011a, 86–89; Vermeulen et al. 2010, 19–28). These initiatives aim to implement standards, namely, directives suggested or imposed by a rule-setting actor to a rule-abiding actor on how to act in a given context, in production processes.

Self and private regulation may take many forms and no single definition is entirely sufficient to describe these phenomena. Many of these private regulation systems are transnational and constitute a body of rules, practices, and processes created primarily by private actors (see Cafaggi 2011, 20–21 and above). Rules and processes alone are not enough – there are real challenges to make them alive in practice, at company and at value chain levels. This raises the question of learning and human resource management.

### 1.4.3 Conceptual specifications for regulatory systemic innovations

A number of the above mentioned regulatory systems have been initiated in small networks, in “niches” which have later developed further and broadened (Smith 2007). In order to express clearly who are involved in different self or private regulation systems, researchers use different concepts, such as pure self-regulation or civil regulation. These concepts also illustrate the extent of the different networks.

Pure self-regulation (Prosser 2008, 100–101) implies no external (the state or other stakeholders) involvement or control in the regulatory process and the conduct of regulated organizations (Bartle & Vass 2005, 19).

It differs from the condition of no regulation in that there is an explicit attempt to regulate conduct. Self-regulation is a tool of the private sector. Much of it has nothing to do with public policies because businesses are doing something voluntarily for their own ends and there is not necessarily any overlap with regulation.

Sometimes regulation and self-regulation co-exist in the same field. Any regulatory regime is not characterized by a single model but is a cocktail of various techniques with interventions by both private and public actors (Prosser 2008, 102; Sorsa 2009d,101–119).

Vogel who is a well-known researcher of the CSR uses the notion of civil regulation to describe the schemes in which civil society actors have been active in creating, monitoring and enforcing the rules. We use the notion private regulation as a synonym for civil regulation. The organizational or institutional sources of civil regulations vary widely (See Bartley 2007). They include NGOs, such as the World Wildlife Fund, Greenpeace, the Clean Clothes Campaign, and Amnesty International.

According to Vogel (2008, 9), civil regulation is distinctive from most traditional forms of industry self-regulation in three important respects. First, civil regulation requires the firms to make expenditures that they would not otherwise make. This is contrary to the aim of the technical standards whose primary purpose is to lower the transactions costs of the market transactions. Second, compared to pure self-regulation, civil regulation is more likely to be politicized: it has typically emerged in response to political and social pressures on business, often spearheaded by national and trans-national activists who have embarrassed global firms by publicizing the shortcomings of their social and environmental practices. Third, compared to pure self-regulation, the governance of civil regulation is more likely to be transparent, contested, and involves either formally or informally non-business constituencies. (ibid.)

The business context is an important factor for the success or failure of the regulatory standards. There is a growing evidence of the range of circumstances where self and private regulation can be remarkably effective and efficient means of social control (Willems et al. 2005; Ollinger & Moore 2009; Sorsa 2011a).

According to an American study conducted by the United States Department of Agriculture the management-based actions which cover different standards, account for about two-thirds of the reduction in samples testing Salmonella, while process regulation (hard law) account for about a third of the reduction. Contracts in value chain reinforce product food safety since sellers must adhere to quality standards. (Ollinger & Moore 2009, 18–19; Jaffee & Masakure 2005 and Starbird 2005).

The past twenty years have witnessed a surge in self-regulatory regimes in Europe, the USA and other advanced economies. These kinds of proactive policies have been developed especially in the food sector in parallel with the public and private sectors.

## 1.5 PROACTIVE LAW'S CONTENT PERSPECTIVES

In order to give students a clear picture of the different systems we will build an example around food safety management. The different self or private regulation schemes can also be called quality assurance schemes (QAS) which is a commonly used notion and reflects the core goal of these schemes. There is a large number of QAS applied within the food supply chain, but most of them are only applicable for small differentiated markets or for a certain part of the value chain. This means that a company needs to be aware of the standards and their requirements on the market segments they are or will be active. The company also needs to know how to participate in the schemes and how to develop them. What the role of a single company concerning private regulation will be also depends on the market structure and negotiation power of the actors. This means that networking with stakeholders and with different professionals is important.

The QAS do not take a uniform approach as they are aimed at different quality aspects and are proposed by different stakeholders. The QAS can be classified on the basis of many different variables. Some of the variables are listed below:

- focus,
- targets (b2b, b2c or b2p),
- content (traceability, method of production, etc.),
- areas of application (local/national/international),
- number of stages involved along the food supply chain.

The focus of the QAS influences the contents of the standard's requirements and is often centered on the product and/or production process characteristics. In a global value chain, there are several challenges for the value chain actors (food safety, traceability, differentiation). Value chain actors can use self and private regulation in order to develop solutions to these common challenges and opportunities (Sorsa 2009d).

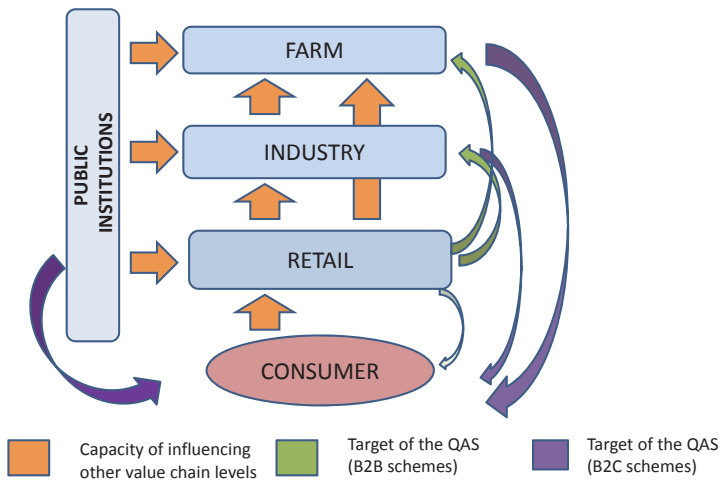
In proactive law, two dimensions of proactivity can be distinguished: the prevention side and the promotion side when analysing the content of the standards. If the common goal of a value chain is to manage food safety, the actors can either have a preventive or a promotional focus. Prevention focuses on risk management. Promotion, again, focuses on promoting good behaviour, learning best practices and continual improvement. Prevention or promotion approaches affect the goals of the scheme. They are expressed in the mission and in the standard. Some private regulation schemes are focused on risk management (e.g. GLOBALG.A.P.), others are more focused on promotion of best practices in order to achieve broader goals like conservation of biodiversity or social responsibility etc. (e.g. Rainforest Alliance, Fair Trade, UTZ Certified; see Sorsa 2010b).

As a rule, when the aim of the actors is mainly focused on risk management they do not raise the level of self or private standards' criteria considerably higher than the requirements of the law. Even if this is the case, self and private regulation can promote international trade by facilitating the compliance with legal issues by packaging all requirements into one standard. This makes it easier for the developing country exporter to find out the requirements needed in order to get into the European food markets (Chia-Hui 2006). When the objective of the actors is promotion they focus on opportunity management. In this case, the private regulation system is often aimed at "differentiating" the product or production process with the issues of environment and biodiversity protection, animal welfare protection, ethical aspects of production etc. If the production takes place in a developing country, the regulation system is aimed at helping an access to markets.<sup>12</sup>

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12 Food quality assurance and certification schemes. Stakeholder Hearing 11/12 May 2006, 19.





**FIGURE 4.** *Quality assurance of food value chain by public and private actors.*

What the goal of a self or private regulation scheme will be, is also dependent on the target group (b2b or b2c) (Willems et al. 2005, 19). Some of the schemes are targeted to consumers and some to the other operators of the food value chain. (Figure 4). When the main target of the schemes are consumers they are generally identifiable by a logo in order to inform consumers about the special content of the product and/or the quality of the process (Figure 5). A logo also functions as a marketing device and encourages consumers to buy these products. This is a way to create new markets by differentiating the products from their competitors<sup>13</sup>. In this sense the scheme may promote environmentally friendly production, bio-diversity, ethical issues, food safety, and so on, to the final customer or to the business or public sector client<sup>14</sup>. Promotion is one aspect of the proactive law definition. In practice, it means that the actors of the value chain create a rule system and processes which suit best their practical purposes (Sorsa 2010b). This is possible because the principle the freedom to contract is commonly adhered to in international business.

13 One could argue that using and creating a logo is only a trademark issue. In this case it is not enough to create a trademark and build a brand because there is a need to have the whole value chain actors involved in the system. – The safety and quality of labeled products also from multinationals such as Del Monte or Dole use e.g. GLOBALG.A.P. standard as a requirement for their suppliers but they market their products under a well-known brands.

14 See e.g. the EU Commission Green Public Procurement Toolkit and the use and role of eco-labels in public procurement [http://ec.europa.eu/environment/gpp/toolkit\\_en.htm](http://ec.europa.eu/environment/gpp/toolkit_en.htm)

If the target is another business partner<sup>15</sup>, as is the case in the GLOBALG.A.P. standards, the communication of risk management characteristics in the food value chain is of importance. Often these schemes are not identifiable to consumers. The aim is to secure that other operators like product or material suppliers comply with the rules specified in the standard. In these schemes the focus is only on risk management aspects of the value chain. (Willems et al. 2005, 18; Sorsa 2011a, 104–109).



**FIGURE 5.** *Categorization of different eco-labels.*

The three examples which will be discussed here are the Fairtrade, the UTZ Certified and the GLOBALG.A.P. certification systems. The Fairtrade and UTZ Certified are used as a marketing tool – the GLOBALG.A.P. is not. They all are applied in food value chain management and can be applied to the same group of products, e.g. coffee. Below, the core idea of these three systems will be explained and then the governance and monitoring systems described.

15 Other food safety schemes are e.g. the BRC. In 1998 the British Retail Consortium (BRC), responding to industry needs, developed and introduced the BRC Food Technical Standard *to be used to evaluate manufacturers of retailers own brand food products*. It is designed to assist retailers and brand owners produce food products of consistent safety and quality and assist with their ‘due diligence’ defence, should they be subject to a prosecution by the enforcement authorities. In a short space of time, this Standard became invaluable to other organizations across the sector. It was and still is regarded as the benchmark for best practice in the food industry. This and its use outside the UK has seen it evolve into a Global Standard used not just to assess retailer suppliers, but as a framework upon which many companies have based their supplier assessment programmes and manufacture of branded products. <http://www.brcglobalstandards.com/about-the-standards/>

### 1.5.1 Applications from proactive law's content perspective

#### *Application for risk management: GLOBALG.A.P*

An example of a certification system whose aim in the food sector is to fend off risks related to food safety in the world, the GLOBALG.A.P.<sup>16</sup> is a private sector body that sets voluntary standards for the certification of agricultural products around the world. It aims to establish one standard for Good Agricultural Practice (GAP) with different product applications suitable to the whole range of global conventional agricultural products. The GLOBALG.A.P. is a pre-farm gate standard, which means that the certificate covers the processing of the certified product of farm inputs, such as feed or seedlings, and all the farming activities until the product leaves the farm. Moreover, it is a business-to-business label not directly visible to consumers.

The Global Partnership for Good Agricultural Practice (GLOBALG.A.P) was developed in 1997 by a group of European retailers (See Figure 2, zone 2). While initially only applying to fruits and vegetables, it now covers meat products and fish from aquaculture as well.

Through certification, producers demonstrate their adherence to the GLOBALG.A.P. standards. For consumers and retailers, the GLOBALG.A.P. certificate (See appendix 1) is a reassurance of food meeting the accepted levels of safety and quality, and that it has been produced sustainably, respecting the health, safety and welfare of the workers, the environment, and in consideration of animal welfare issues. Without such reassurance, farmers may be denied access to markets (e.g. Willems et al. 2005, 19). Complying with the standard the farmer complies with the EU standards and WTO codex alimentarius standards at the same time. (Sorsa 2010c, 76–86).

#### *Application for opportunities for social welfare: Fairtrade*

A well-known label and an example of a certification system whose main aim is to advance and promote equal opportunities of producers and farmers in the third world is the Fairtrade. The Fairtrade certification system is an independent certification and labeling system to guarantee the fulfillment of the principle of equity and development in North-South trade. (Sorsa 2010c, 91–95).

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16 Sorsa 2010c, 76–86 and GLOBALG.A.P. official website: [www.GLOBALGap.org](http://www.GLOBALGap.org).

The organization behind the scheme is the Fairtrade Labelling Organization (the FLO). It was founded in 1997 by 17 national labelling initiatives that wanted to adopt a uniform approach. Fairtrade labelling was conducted independently by “national initiatives” (labelling initiatives) *formed by the NGOs or fair trade companies* in European and North American countries until the year 1997. At that time, the FLO was created to form an umbrella organization for coordinating the activities of the national initiatives (See Figure 2, zone 6).

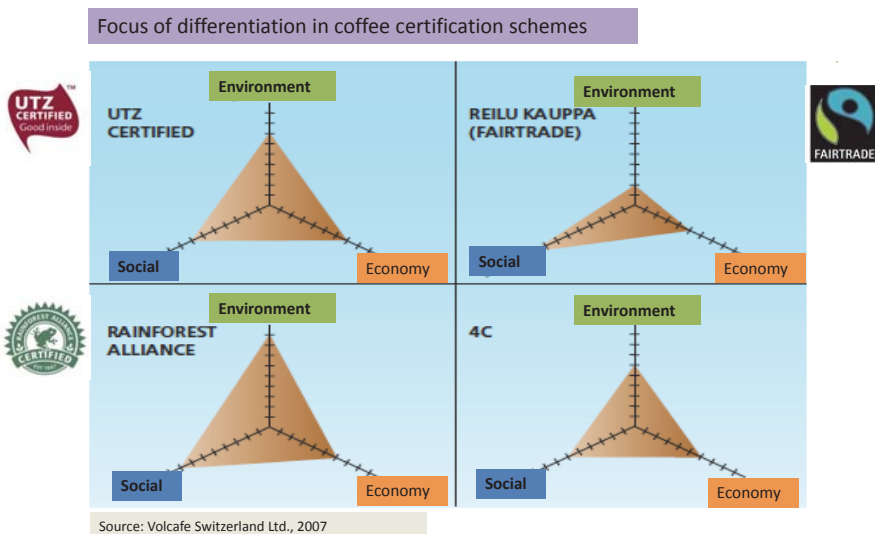
The mission of the FLO is: “... to connect consumers and producers via a label which promotes fairer trading conditions, through which producers who are disadvantaged by conventional trade can combat poverty, strengthen their position and take more control over their lives” ([www.fairtrade.net](http://www.fairtrade.net)). It is unique in its requirement that both producers and buyers observe a set of rules to earn certification. Fairtrade was conceived with a social mission, fair price for the farmers, but its standards have increasingly incorporated environmental criteria (focus element) as well. Fairtrade can be described to be a scheme targeted to the final consumer and it has its well-known logo (Figure 6.) The content of the system is directed partly to the production methods and also to the trading practices as it requires the fair trade price for the farmers.

Questions:

- 1) If we look at the goal of the Fairtrade regulation system, could this kind of system be created for international trade by international hard law?
- 2) Why can we say that this system is an example of proactive law?
  - a. Argue from the FLO company perspective
  - b. Argue from a retail company perspective
- 3) What is the main focus of fair trade regulation – prevention or promotion?
- 4) Which stakeholders are important from the retail company perspective, if it is willing to take Fairtrade products to its product selection?

*Application differentiation with ecological and environmental issues:  
the UTZ Certified*

Ecological and environmental issues are often best promoted by private regulation. An example of such a certification system that is particularly devoted to differentiating products based on environmental sustainability issues in the coffee sector is the UTZ Certified<sup>17</sup> system. It is a market-oriented sustainability programme that strives to create a transparent marketplace, traceability as a key element, and sustainable supply chains for agricultural products. The mission of the organization is “to be a worldwide certification program that sets standard for responsible coffee production and sourcing” (UTZ Certified). The UTZ Certified code of conduct for coffee is a set of criteria for environmentally and socially responsible coffee production and efficient farm management and is open to farms of all sizes. (Sorsa 201c, 90–91).



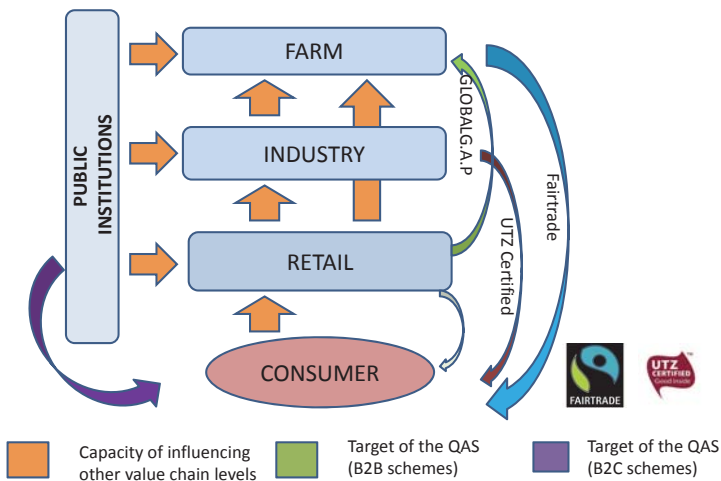
**FIGURE 6.** *Differentiation with different private regulation systems*

The UTZ Certified organization was founded by a Guatemalan coffee producer and the Dutch retailer Ahold (see Figure 2, zone 2). The company in large part set standards in conjunction with its Guatemalan coffee suppliers to meet the GLOBALG.A.P. agriculture protocol. The UTZ Kapeh foundation was

17 See <http://www.utzcertified.org/index.php>

established to grow the initiative and enhance its credibility through an independent certification system and multi-stakeholder governance structure. The objectives were to create an instrument that would allow mainstream coffee companies to trace their beans to the original source and to establish basic sustainability standards in the global coffee market.

The targets of the UTZ Certified scheme are the final consumers for whom the sustainability is marketed by a logo (See Figure 7). This also represents the promotion part of the proactive law. The UTZ Certified also has a risk management element as it is focused on traceability of the coffee beans. If the retailer is going to market its coffee as sustainable, it should be able to also verify that the coffee really is produced sustainably. A traceability system makes this possible.



**FIGURE 7.** Standard setters and targets of three private regulation systems.

### 1.5.2 Summary

Self and private regulation schemes can contribute to the content of the proactive law concept at least in three different aspects. They can help obstruct risks from materializing at the same time they promote opportunities. They can advance equal opportunities and fair treatment of producers and workers, particularly in the developing countries which provide the whole world with

commodities and alimentation produce. A certification system whose aim in the food sector is to fend off risks related to food safety in the world is the GLOBALG.A.P. A well-known label to the consumers all over the world and an example of a certification system whose main aim is to advance and promote equal opportunities of producers and farmers in the third world is the Fairtrade. Ecological and environmental issues are often best promoted by private regulation. An example of such a certification system that is particularly devoted to differentiating products based on environmental sustainability issues in the coffee sector the UTZ Certified.

Figure 7 illustrates the business goals of these three different self-regulation (the UTZ Certified and the GLOBALG.A.P.) and private regulation (Fairtrade) schemes. They are aimed at creating different value chain opportunities or respond to challenges even though their two common goals are food safety and environmental issues. Another aspect is that they are all voluntary to the companies. They aim at promoting goals which are felt to be common for multiple actors in the value chain and also important to the general public.

## 1.6 PROACTIVE LAW'S PROCESS PERSPECTIVE – STANDARD-SETTING, IMPLEMENTATION, MONITORING

The legislative, executive and judicial functions of private regulation are analogous to the public sector law making and enforcement processes. What is special compared to the traditional notion of law and what is emphasized in proactive law are the enabling and empowering elements, user friendliness and the facilitative characteristics of these schemes (Sorsa 2011a, 140–147). To consider these three functions – the legislative, the executive and the judicial – is important when we talk about proactive law. According to the description of Proactive Law in the EESC Opinion, “proactive law is about enabling and empowering – it is done by, with and for the users of the law, individuals and businesses.” The opinion continues, “the Proactive Law approach looks for a mix of methods to reach the desired objectives: the focus is not just on legal rules and their formal enforcement. (EESC Proactive Law Opinion). (See also Sorsa 2009c, 35–70).

It is important to analyse these functions because questions concerning them are posed when the role of private regulation in global business is discussed (Sorsa 2011a, 196–198). These are also issues which the company needs to

consider before making a decision to participate to schemes or when the buyer is suggesting them to the company. Finally, the company needs to consider these questions, when analyzing the stakeholder networks in which it should participate, in which way to participate and nominating people (quality manager, CSR manager, product manager, Contract manger) who should participate.

### 1.6.1 Empowerment in standard setting

The legislative function explains who has the authority to set the rules in the private regulation scheme. The separation of legislative, executive and judicial functions provides systematic checks and balances to help ensure that a single voice does not override the voices of all others (Sexsmiths & Potts 2009, 7; Sorsa 2011a, 144). Standard-setting is the core of the legislative function.

We can get some guidance from the EESC PLA opinion for the proper *legislative function*. According to the opinion what is characteristic of proactive law is that it ”involves stakeholders early, aligns objectives, creates a shared vision, and builds support and guidance for successful implementation from early on” (EESC Opinion 1.6). These guidelines are in accordance with the better regulation guidelines of the EU and of the OECD as well (Sorsa 2009c).

Standard-setting means the introduction and operationalising of the standards through the formulation of written rules and procedures (Henson & Humphrey 2009, 7). *Standard-setting procedures* guide the standard-setting organization and help build stakeholder confidence and commitment to the standard-setting process. These *procedures* shall be made available to interested parties, who shall be provided opportunities to comment on the procedures. Procedures shall be made available at least through the organization’s website.<sup>18</sup>

From the different self and private regulation schemes’ viewpoint it is important to consider *how and where these systems involve different stakeholders*. This is important because private rules in the form of standards, for example, have far reaching consequences affecting a wide range of actors, such as consumers and suppliers all over the world (Fuchs & Kalfagianni 2010). From a single company perspective it is important to decide, how a single company can get its voice heard and be noticed in private regulation systems.

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18 ISEAL Code of Good Practice, Setting Social and Environmental Standards v5.0, 5.



Enabling and empowering elements of proactive law emphasize the role of different actors (Sorsa 2011a, 142, 157–162). Framework for assessing participatory governance is an essential mechanism for achieving legitimacy for the scheme. Participatory governance is defined in practice by active participation in decision-making, which can empower impoverished members of society by improving their access to citizenship rights and to resources. Participatory governance can enhance the efficiency and effectiveness of private regulation by integrating the needs of different stakeholders into decision making processes. ISEAL Code of Good practice in standard-setting gives guidelines for proper processes<sup>19</sup>.

Upon commencement of any new standard development activity, the standard-setting organization shall develop terms of reference, which shall include the following elements: e.g. “The standard-setting organization should work to refine the objectives of the standard at an early stage, as this will make it easier to identify which different interest groups will be impacted by the standard. Relevant interest sectors need to be defined by the standard setting organization and can include but are not limited to: producers, consumers, traders, retailers, unions, NGOs, indigenous groups, governments, local authorities, international organizations, researchers and academic bodies. Inspection and certification bodies should be included to help to ensure the practicability and auditability of the end result. The standard-setting organization also needs to be proactive in identifying and involving disadvantaged groups” (5.1.1.). Key stakeholders shall be proactively approached to contribute to the consultation (5.3.2.) and also “standard-setting organizations shall identify parties who will be directly affected by the standard and those that are not adequately represented and proactively seek their contributions” (5.7.2.). ([www.isealalliance.org/code](http://www.isealalliance.org/code))

Collective private standards, whether developed by industry organizations or private standard coalitions, often tend to be elaborated by technical committees consisting of member companies and, in some cases, external experts, representatives of suppliers, etc. In many of these organizations, the secretariat plays a key role in directing the standard-setting process. The central aim of the standards elaboration process is *to reconcile the competing needs and demands* of the ultimate adopters of these standards; private standards are of no use unless they are adopted (Henson & Humphrey 2009, 21; Sorsa 2011a, 157–159).

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19 ISEAL Code of Good Practice, 7.

The creation of collective private food safety standards is generally undertaken through a “semi-closed” process, especially where the membership of the organization elaborating the standard includes the key standards adopters. Typically, a multi-tiered decision-making structure exists that allows for technical inputs from members of the industry organization or standards coalition, and also other ‘invited’ stakeholders (Henson & Humphrey 2009, 22).

There are a couple of values important in standard-setting process corresponding with two democratic principles like rule of law and sovereignty of people: representation and equity (Sexsmiths & Potts 2009, 11–13; Sorsa 2011a, 157–159).

**Representation:** The variety of viewpoints held within the population is fairly reflected in the composition of delegates to governing bodies.

The actors along the value chain try to maximize their share of value added. This implies they will bring competing viewpoints to value chain decision-making. These perspectives should be represented in standards governance in proportion to the support they receive from value chain stakeholders. This means that in commodity sectors like food industry this implies special consideration of the perspectives of producers, particularly developing country producers, who are typically marginalized in decision-making processes. (op.cit, 14–20).

**Equity:** Stakeholders have equal opportunities to influence decision-making processes.

Stakeholders should enjoy equal opportunities to influence decision-making processes in standards organizations, since the decisions made have impacts along the value chain. This means in practice that there should be put in place formal voting structures that prevent any set of interests from being excluded from decision-making, as well as policies that aim to equalize opportunities to make active governance contributions. (op.cit., 28–34).

Standards affect executive value chain governance by providing support that affect uptake and implementation (Sorsa 2011a, 159–162). Although the executive power of any given standards body is ultimately the responsibility of its board of directors (or its general assembly), the use of executive power is for the most part delegated to central secretariats. Standards bodies may also undertake to facilitate more widespread and effective adoption of their initiatives including financing, technical assistance and communication as well as marketing activities (Sexsmiths & Potts 2009, 9).

## 1.6.2 Implementation

The implementation phase can be divided into two: *adoption and implementation*. Adoption means a decision by an entity to adopt the standard. This can take various forms. (Sorsa 2011a, 159–162).

- a) A private company can adopt a standard by requiring its suppliers to use it. This could be a standard developed by the company itself (e.g. IKEA standards), or one it helped to develop for example as part of a standards-setting coalition, or a standard created by another body.
- b) Equally, groups of producers can develop a standard which they themselves adopt (e.g. ISO 9000 or ISO 14000 standards).

The decision to adopt is an important driver of the spread and influence of private standards. This stage of standards development is sometimes under-emphasized.

The *implementation* of the rule is carried out by the organization that is conforming to the standard. This will not be the standard-setter. In the case of standards like the BRC or Global Standards for Food Safety, the implementer is the company that applies the standard in its own operations. The stakeholders who implement the standard are very crucial actors of the private regulation (Henson & Humphrey 2009, 7). Therefore the ISEAL Code emphasizes the role of them in its guidelines (ISEAL Code of Good Practice for Standard-Setting 5.7.2):

*Parties that will be directly affected by the implementation of a standard are the most important stakeholders in the standard-setting process. As such, it is important that standard-setting organizations take a proactive role in supporting these stakeholders to participate.*

The design, implementation and evaluation of compliance with criteria established in a standard (the legislative, executive and judicial branches respectively) should be reasonably independent and have relatively equal power within the overall organizational structure. This should prevent decisions from being made in the interest of any particular stakeholder to the exclusion or detriment of others.

### 1.6.3 Monitoring: Conformity assessment and enforcement

Monitoring involves the procedures employed to verify that those claiming to comply with the standard and provide documented evidence to show that this is the case. There are various means of assessing conformity, including self-declaration by the implementer of the standard, inspection by standards adopter (second party certification) and inspection by a third party (third party certification). Third-party certification carried out by independent certification bodies has become the norm for many private food safety standards. Standards schemes also include processes for recognizing the certification bodies that are allowed to verify compliance. (Henson & Humbrey 2009, 7; Sorsa 2011a, 160–162).

Components of a compliance system in self- and private regulation			
Monitoring function			Sanctioning mechanism
Approach	Method of assessment	Source of assessment	
<i>Proactive monitoring</i>	Self-assessment	Desk based	Recommendations for corrective action made, but kept confidential. ..... And disclosed publicly Financial penalty imposed
	Peer assessment	Interviews/ surveys/ visits	
	Third party assessment	Both	
<i>Reactive monitoring</i>	Complaints procedure	Depends on nature of complaint	Membership suspension/expulsion
			Expulsion publicised

**FIGURE 8.** *Monitoring compliance and sanctioning in self and private regulation. (Lloyd, Calvo & Layborn 2010, 5).*

It is very important that the objectives of the standard are clearly and explicitly specified. According to the ISEAL Code “clear objectives are the basis on which many of the other aspects of a standard system builds. Clear objectives can underpin a logical standard structure and contribute to an effective monitoring and evaluation program.” ([www.isealalliance.org/code](http://www.isealalliance.org/code), 6.1.1.)

It is obvious that the proactive monitoring methods should be emphasized rather than the mere reactive monitoring methods. When well-organized and well-functioning, these methods can reduce the need for reactive monitoring.

Enforcement means responding to non-compliance and sanctions which, in effect, would be the withdrawal of recognition, if corrective action is not taken<sup>20</sup>. The standard has to have some procedure for responding to the results of the conformity assessment, either by invoking corrective action or withdrawing the recognition of the organization as conforming to the standard (Henson & Humbrey 2009, 7). According to the ISEAL Code:

*Administrative requirements relating to conformity assessment and marks of conformity shall be presented separately from technical, process or management requirements. Requirements that may facilitate conformity assessment but that do not directly contribute to the achievement of the stated objective, such as onerous documentation requirements, should be avoided.* (www.isealalliance.org/code 6.3.4).

#### 1.6.4 Assessing the schemes from general public viewpoint

Different self and private regulation schemes can be evaluated using the same criteria as evaluating public regulation schemes (See Figure 3). In private forms of governance, *effectiveness* is a crucial criterion for their legitimacy, because it is frequently identified as their claim to legitimacy. Private actors, after all, are not elected to political office, providing them with the authority to set rules and determine the societal allocation of values. Rather than drawing authority from democratic elections and formal office, legitimacy claims of private rule setting tend to derive from the notion that it can *provide certain governance functions more effectively and efficiently than elected public actors*. (Kalfagianni & Fuchs 2011)

*Effectiveness means that goals are realized to the satisfaction of all affected groups.* Clear strategic management, complemented by processes of monitoring and evaluation and corresponding *systems of continual improvement*, are prerequisites for ongoing effectiveness in governance. Developing a particular set of criteria or rules, however, does not ensure effectiveness on its own. Standards should improve the effectiveness of governance by *establishing a consistent relationship between rules and implementation systems*. (Sorsa 2011a, 162–164)

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20 See e.g. Setting Social and Environmental Standards v5.0. ISEAL Code of Good Practice rules for compliance rules 4.4.1 and 4.4.

Effectiveness can be measured along three dimensions: output, outcome and impact<sup>21</sup>. The particular standard can be considered as output. The actual change in business conduct achieved in the course of a standard's implementation, i.e. contribution to problem-solving, represents the outcome. The general change resulting from the interaction with additional economic, social and political externalities is the impact. The question about the effectiveness of private governance has to refer to changes in business conduct achieved in the course of the implementation of the agreed standard (outcome). This outcome is a function of the agreed standard (output) and of existing incentives and opportunities to meet the standard, to outperform it or to fail to comply. After all, not only the regulations defined by the private standard are of interest here. Rather, the implementation of the private standard and the change in actual conduct achieved by that implementation matters. At the same time, the private regulation cannot be held responsible for simultaneous developments in complex socio-economic systems, at least not by itself. (Sorsa 2011a, 162–164)

Efficiency means that the cost-benefit ratios of initiatives are maximized. Standard organizations should contribute to efficiency by strategically orienting their financial resources toward their core objectives – sustainable development and, in particular, satisfying the needs of disadvantaged parties – and by reducing overlaps and duplication in governance and implementation. (Sorsa 2011a, 145)

Accountability means that the decision-makers should be easily identifiable and responsible to stakeholders so that the organization of value chain activities is efficient and fair (Sorsa 2011a, 146–147). Accountability and transparency<sup>22</sup> go hand in hand. Transparency, in short, is often associated with a more accountable, legitimate, effective and democratic governance. External transparency can improve the legitimacy and accountability of organizations to relevant stakeholders and society at large through provision of information to actors not directly participating in organizational structures and procedures (Gupta 2010). In this context, transparency has an empowerment potential

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21 Kalfagianni and Fuchs (2010) are in favour of two-dimensional understanding of effectiveness. It includes the uptake of and compliance with the relevant rules and standards, as well as the broader structural, cognitive and regulatory effects associated with the development and exercise of transnational rules.

22 See e.g. ICANN Accountability & transparency Frameworks and Principles 2008. ICANN is the Internet Corporation for Assigned Names and Numbers formed in 1998. It is a not-for-profit public-benefit corporation with participants from all over the world dedicated to keeping the Internet secure, stable and interoperable. It promotes competition and develops policy on the Internet's unique identifiers.

by satisfying stakeholders' "right to know" and creating opportunities for intervention and change.

### 1.6.5 Applications from proactive law's process perspective – The organization of the standardisation work

Next, the organizational structures of the three case examples will be analysed. The Fairtrade scheme is organized as an association, the UTZ Certified was established as a foundation and the organizational structure behind the GLOBALG.A.P. is a non-profit limited company. According to the ISEAL Guide, it is important that standard-setting organizations take a proactive role in supporting the implementing organizations to participate in standard-setting processes. All these three systems have existed already more than ten years and they have been developing towards more democratic governance structures.

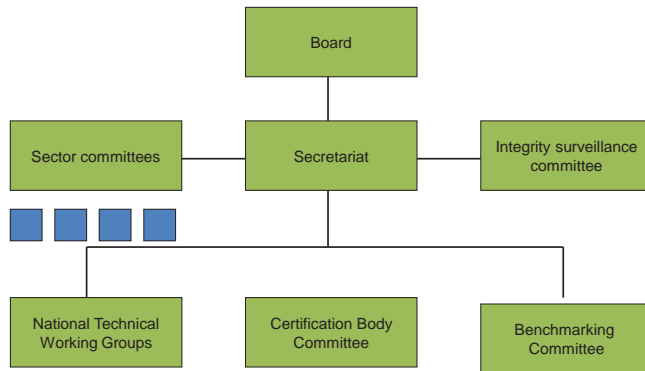
#### *Governance of the retailer driven GLOBALG.A.P. scheme*

The retailer driven GLOBALG.A.P. *foundation* partnership is open to any organization. There are different types of memberships for producers/suppliers, retailers and associates. Governance in the GLOBALG.A.P.<sup>23</sup> is organized by a Board whose decisions are based on a structured consultation process (Figure 9). Sector specific interests and multi-stakeholder input are consolidated to ensure global acceptance. Sector Committees<sup>24</sup> discuss and decide upon product and sector specific issues.

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23 Sorsa 2010c, 76–86. See also the earlier phase of development in Amariei 2004.

24 The GLOBALG.A.P. Sector Committees were established by agreement of the GLOBALG.A.P. Board in March 2006. In 2007 the SCs replaced the Technical and Standards Committee (TSC). The SC members are elected for a period of three years by their peers (Supplier and Retailer GLOBALG.A.P. members). The SCs mostly work independent from the Board but within the policy framework created by the Board. SCs are responsible for technical decision-making relevant to their sector while supported and guided by the GLOBALG.A.P. Secretariat to aid consistency and harmonisation. The Board finally adopts standards developed or revised by the SCs. [www.GLOBALGap.org](http://www.GLOBALGap.org)



**FIGURE 9.** *The GLOBALG.A.P. governance structure.*

GLOBALG.A.P. is organized with equal participation for retailers and agricultural producers. According to ISEAL Guide parties that will be directly affected by the implementation of a standard are the most important stakeholders in the standard-setting process. Standard-setting process is organised according to the ISEAL Guide (Sorsa 2010c, 80–81). This has been taken into account in GLOBALG.A.P. scheme since 2001 as the Committees have been constituted of equal numbers of retailer and producer/supplier seats. Acting collectively the GLOBALG.A.P. *Board members* represent the views of their respective membership constituency (producer/supplier or retailer) rather than their individual companies or affiliated associations. The GLOBALG.A.P. *Board has a full governance role* in developing GLOBALG.A.P. strategy and overseeing its implementation.

Members of standards development committees are typically *appointed or elected* by boards. This selection procedure enhances the efficiency of the process, *but it also reduces opportunities for direct participation by the stakeholders who are directly affected by standards content.* The power to elect members to the committees is one tool to allocate power in the scheme.

*Executive functions* of the GLOBALG.A.P. are carried out by the FoodPLUS GmbH, a non-profit limited company<sup>25</sup>. The executive management of FoodPLUS GmbH, i.e. its Managing Director, bears responsibility for *the implementation of policies and standards.* The secretariat plays a key role in

25 FoodPLUS based in Cologne, Germany, fulfilling a secretariat function for GLOBALG.A.P. [www.GLOBALGap.org](http://www.GLOBALGap.org)



directing the standard-setting processes as well. Financial and legal ownership and responsibility for FoodPLUS GmbH is held by the EHI Retail Institute. The EHI Retail Institute also operates the European Retail Academy, a global network of research institutes linked to retail activities and topics. This means that the work of GLOBALG.A.P. organization is closely linked with the research networks of retail sector but also that it is closely linked with the funds from retail business.

In conclusion, the GLOBALG.A.P. scheme is a risk management tool for global value chain and its *governance structure* is fairly well developed during its 15-year existence. Smallholders positions have improved during the last ten years with the smallholder group certification options (Will 2010, 31). One critical point is the fact that consumer organizations do not have a formal representative in the governing bodies. The voices of consumers are channelled via public consultation rounds and via national technical committees. *Also public authorities are a group with whom the GLOBALG.A.P. does not have formal co-operation.* However, there are differences between countries in this respect as, for example, when the GLOBALG.A.P. was brought to Kenya there was co-operation with public authorities as well. (Sorsa 2010c, 83–86).

### *The trajectory of Fairtrade multi-stakeholder scheme's governance*

Fairtrade Labelling Organizations International is an association (FLO)<sup>26</sup>. The purpose of the association is the support and promotion of aid and co-operation leading to sustainable development by means of improving the position of disadvantaged producers and workers in countries of the developing world, working as associations of small-scale producers and as worker organizations.

Full membership of the association is open to Labelling Initiatives and Producer Networks<sup>27</sup>. Labelling Initiatives mean organizations with an exclusive, defined geographical territory whose main purpose is to licence a Fairtrade Label and who do not primarily pursue commercial interests<sup>28</sup>. The members of the association aim to facilitate the access to markets for the goods and services coming from these target groups. In order to achieve this goal, the members of

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26 It is registered as a not-for-profit association (“eingetragener Verein”) under German law.

27 The total number of farmers and workers in the Fairtrade system was 1.15 million at the end of 2010, and that this will have exceeded 1.2 million during 2011. Kilpatrick 2011, 12

28 E.g. Finnish Fairtrade Labelling initiative is called “Fairtrade Finland”.

the association have, in close co-operation with other partners, developed the instrument of Fairtrade labeling.

*The General assembly* is the highest authority in FLO (compare with GLOBALG.A.P and the power of Board). It is composed of one seat for each of the nineteen labelling initiatives and three producer networks. General assembly elects the 14 board members, which are formally assigned for labelling initiatives (five seats); producer organizations (four seats); traders (two seats); external, independent experts (three seats). The different stakeholder groups have different number of seats and power in the scheme.

The standards committee is responsible for development of all Fairtrade standards. The board appoints its members and ratifies the decisions it considers to be major. The number of members must be between five and eleven, and must be odd. The principal of representativeness is put into practice:

Appointments must ensure a balance of “suppliers” and “users” of standards, as well as experts. The supplier category must include at least one representative each from producers and workers, as well as a FLO liaison. The user category must include at least one member from the labelling initiatives and one from traders. Experts include independent experts, who have voting rights, and representatives from each of the FLO inspection and certification systems and the FLO Producer Business Unit, who do not have voting rights. The three producer seats on FLO’s Standards Committee formalize developing country representation. Standards committee members are appointed by the board.

Fairtrade standards are set in accordance with the ISEAL Code of Good Practice on Standard Setting. This process involves wide consultation with stakeholders. The standard-setting process is managed by FLO’s Standards Unit, which publishes its annual work plan as part of good practices in standards setting. From PLA viewpoint this means that the actors of food value chain have an opportunity to be heard and to influence to the contents of different Fair Trade standards. *Decisions about Fairtrade Standards are made by the FLO Standards Committee.*

The outcomes of the standardization process are different product and process standards. From a proactive law perspective it is important to point that Fairtrade standards distinguish between minimum requirements, which producers must meet to be certified, and progress requirements that encourage producers to continuously improve and to invest in the development of their organizations and their workers. This concept is developed for the target group of Fairtrade:

disadvantaged producers. It encourages sustainable, social, economic and environmental development of producers and their organizations. From the proactive law viewpoint we can find that the content – the outcome of the standard setting process matters: if the standard would only set minimum requirements it would be quite static. Instead when the standard sets also progress requirements it is dynamic and forward looking.

The evolution history of the Fair Trade organization started in the 1970 decade. From the democratic decision making perspective the year 2003 was remarkable for the organization of Fair Trade. In autumn 2003, the FLO spun off Fairtrade certification and inspections to a separate organization, FLO-CERT, to make certification even more transparent. Separation of standard-setting and monitoring activities is one of the most crucial elements for the accountability of the scheme.

With the setting and control of standards now separated, the Fairtrade certification system could apply for ISO 65 accreditation and gain an external guarantee for the reliability of the system. FLO-CERT received ISO 65 accreditation in 2007 – a worldwide first for any social certification system. This was the final proof of the superior reliability of Fairtrade certification and has strengthened its position as the leading certification system in the sector.

FLO has also developed its membership structure by increasing the level of participation of a key stakeholder group, the producers of Fairtrade certified products, in the organization. This strengthens the extent to which their interests are represented in decision making.

Until recently, only Labelling Initiatives such as TransFair and Fairtrade Foundation, were formal members of FLO. A vote in November 2007 by the General Assembly, however, led to the adoption of a new constitution that extended membership status to networks of Fairtrade certified producers. These are recognized as the representatives of farmers and workers in the developing world. With this modification the regional aspects are also better taken into account in standard-setting. The producer Networks, CLACC (Coordinadora Latinoamericana y del Caribe de Comercio Justo), AFN (African Fairtrade Network) and NAP (Network of Asian producers) now have their own Producer Network Assembly alongside the Labelling Initiatives Assembly and the General Assembly, where they discuss issues of relevance to them, and are allocated four places on the Board of Directors (with Latin America, Africa and Asia having at least one seat each). (Lloyd, Warren & Hammer 2009, 46).

The inclusion of producers as voting members of the organization represents an important step towards FLO becoming a truly multi-stakeholder organization. Moreover, it is important that producers are co-owners of FLO as its very purpose is to improve their situation and therefore, it needs to know their priorities. By involving producers in the governance structure in this way, FLO is better placed to respond to their needs and set standards that support their interests. (Lloyd, Warren & Hammer 2009, 46). Even though Fairtrade organization was from the very beginning considered to be a multi-stakeholder organization (Figure 2, zone 6), the continuous improvement belongs to the nature of the scheme.

Empowerment via Fairtrade can be concretized analysing political and economic impacts of the scheme. There is some evidence of the impacts of the Fairtrade scheme both from empowering and enabling viewpoints. These conclusions are based on summary reports and analysis written by different researchers all over the world<sup>29</sup> and on the report “Monitoring the Scope and Benefits of the Fairtrade” (Kilpatrick 2011) which was published in the end of 2011.

Empowerment inputs of the Fairtrade are created in the social development principles of Fairtrade. These principles are of particular relevance to political empowerment. Economic inputs (e.g. capacity building to reach new export markets, support for producer networking and advocacy activities) also shape economic empowerment. The areas of producer<sup>30</sup> empowerment cover *improved producer self-confidence, improved market and export knowledge, and greater access to training.*

Fairtrade Premium<sup>31</sup> income plays a crucial role in producer empowerment. Fairtrade Premium is intended for collective use by producer organizations and by workers’ bodies, and as such the organizational-level income may be the most relevant to understanding the potential impact of the Fairtrade Premium in any given context. The Fairtrade Premium has been used for:

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29 See, e.g. Laroche & Guittard 2009: The Impact of Fairtrade labelling on small-scale producers. Conclusions of the first studies, 2009 and Nelson & Pound 2009: The Last Ten Years: A Comprehensive Review of the Literature on the Impact of Fairtrade.

30 At the end of 2010 there were 905 Fairtrade certified producer organizations in 63 countries. This is a net increase of 78 producer organizations since the end of 2009, and is in line with the overall growth trajectory of the previous years. The majority of Fairtrade producer organizations are in Latin America and the Caribbean, accounting for more than half of all Fairtrade producer organizations worldwide. Kilpatrick 2011, 28, 30.

31 In 2009–10, Fairtrade producer organizations reported receiving a total of € 51.5 million in Fairtrade Premium income. This was an increase of 22 percent over the figure reported for 2008. As in 2008, around 25 percent of all Fairtrade Premium incomes went to hired labour organizations and 75 percent to small producer and contract production organizations. Kilpatrick 2011, 46.

- *Community* (e.g. community development projects, community infrastructure, community credit schemes, community disaster relief, support for community institutions such as children's homes or social charities);
- *Education* (e.g. school infrastructure, school supplies, scholarships and bursaries, payment of school fees, teacher training, adult education);
- *Investment in business development* (producer organization level). Investment in the development and strengthening of farmers' organizations are crucial elements from market access perspective. Business development takes place through business training for organization employees and management; development of internal control systems and quality management; development of organizational infrastructure (for example: warehouse and storage facilities, quality checking facilities, export and packing facilities) and equipment; organizational costs and administration. (Kilpatrick 2011, 51).
- Organizational strengthening means increased influence nationally and locally, improved democracy in decision making and levels of participation, stronger organizations able to survive in hard times, and higher ability to attract other sources of funding (Nelson & Pound 2009, 19–30).
- *Investment in production and processing (farmer level)*. These investments concretize in inputs, equipment, and training directed at farm level to support increased yield, quality, or diversification. Training for members in business skills is also taking place.

The guidelines of EESC Proactive Law Opinion stating that proactive law is about enabling and empowering and done by, with and for the users of the law, individuals and businesses seems to apply well in the Fairtrade scheme.

### *Governance of the producer driven UTZ Certified scheme*

The UTZ Certified<sup>32</sup> scheme has developed from producer driven, coffee certification organization to a worldwide accreditation and tracking programme for agricultural production and trade. In 2010, the UTZ Certified formalized its multi-stakeholder character into its governance structure (Figure 10).

UTZ Certified adopted *the board of trustees' governance model* with a *Supervisory Board*. It is the highest decision-making body and shall supervise and give advice to the *UTZ Directorate*. From its inception until December 9th 2010, the Board was a formal board with managerial responsibilities. As UTZ Certified matured to the current organizational level, the Board mandated most of its tasks and responsibilities to the managing directors. Thus, the change of model was a logical step in the development of UTZ Certified.

*Supervisory Board Members* are chosen on the basis of their expertise, experience and objectivity. Supervisory Board members do not represent the stakeholder group of which they may be part, but rather to act in the overall interests of UTZ Certified<sup>33</sup>. Operations are led and managed by the Directors and their staff, without undue interference from the Supervisory Board.

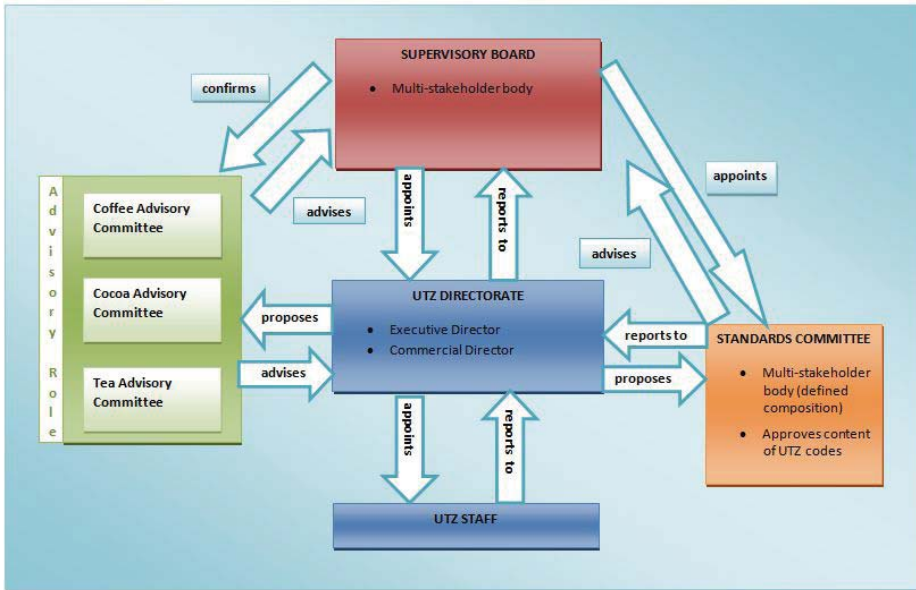
The Supervisory Board is a multi-stakeholder body whose composition reflects a balance between production and consumption interests, as well as encompassing the range of expertise and experience required. There will be minimally one SB member drawn from the following groups:

- a. production;
- b. supply chain (including brands, processors, trade, retailers);
- c. civil society/non-governmental organizations (NGOs) and
- d. trade unions.

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32 UTZ Certified is a (non-profit) Foundation (“Stichting”) established under Dutch civil law by the Notarial Act of 3 July 2001. Following a decision of the Foundation Board taken in May 2007, a fundamental change to its by-laws was carried out. The Notarial Act of 30 August 2007 provides the basis for the current governance structure and procedures of the organization.

33 Compare the GLOBALG.A.P case in which Board members represent their stakeholder group interests instead of their individual companies. In UTZ Certified case they stress the overall interests of UTZ Certified scheme.



**FIGURE 10.** *UTZ Certified governance structure.*

The Supervisory Board will monitor the implementation of the Governance structure at its regular meetings. Changes to the UTZ Certified governance structure and procedures are made by decision of the Supervisory Board and will be published on the UTZ Certified website within 2 months of any substantive change.

*Standards setting* takes place via two committees. *The Standards Committee* and *Product Advisory Committees* provide the fora for stakeholders along the value chain, from producers to buyers to be involved and influence the operations of UTZ Certified. During code-development and revision workshops in origin *all relevant stakeholders are invited to attend and participate*. Whilst the feedback from all the stakeholders is taken into account, the Standards Committee is responsible for approving new product codes (standards), approving changes to existing product codes (standards revisions), dealing with complaints, and ensuring the technical consistency and integration of all UTZ Certified programmes.

The composition of the Standards Committee represents the various stakeholders involved in the UTZ Certified programme. In order to ensure a balanced representation the members of the Standard Committee are grouped into the following categories. The number of representatives for each category is binding.

**TABLE 1.** *Representation of the members of the standard committee.*

Category	Number of representatives	Comments
Producer and Supply Chain representatives	Minimum of 2	
NGOs and Technical Experts on specific sustainability issues such as labour issues, gender, good agricultural practices and biodiversity.	Minimum of 2	
Certification or Sustainability experts	Minimum of 2	
UTZ Certified staff	1–2	Non-voting ex officio member(s)

The UTZ Certified is similar to GLOBALG.A.P., but with additional standards relating to labour and additional services provided, such as market information on coffee prices, which is designed to help producers negotiate fair prices.

### 1.6.6 Summary

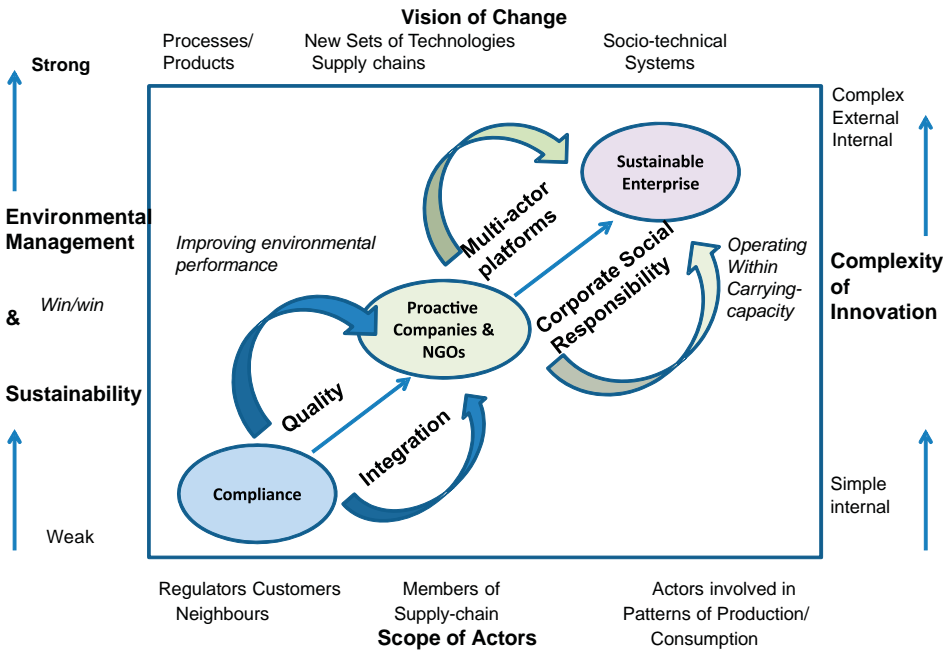
The most well-known self and private regulation schemes are carried out under different organizational structures which frame the functioning of the scheme. Common feature for many of these schemes is that they have transformed to be more open. The accountability and transparency issues have been taken seriously in all of them and the organizational structures have been modified towards multi-stakeholder systems also in GLOBALG.A.P and UTZ Certified schemes. It needs to be emphasized that the organizational structures are important structural elements of proactive law because the fair and open standard-setting processes do not alone guarantee the empowerment of different stakeholders. The seats in the decision making bodies strengthen the role of different stakeholders together with open consultation processes of standard-setting. The NGOs role as an active watchdog has improved the accountability of many self and private regulation schemes.

The phenomenon of regulatory systemic innovations for sustainability is illustrated in Figure 11. The figure sets out the core elements of the innovation process and characterizes this scale a complexity.

The axes relate the strength of environmental management (weak – strong) to the characteristics of innovation. These include the scope of the vision of



change that drives innovation (1) processes/products, 2) supply chain, 3) socio-technical systems), the actors involved the innovation process (1) regulators, customers, neighbours; 2) members of the supply-chain; 3) actors involved in patterns of production/consumption) and the complexity of the innovation (simple/internal; complex/external).



**FIGURE 11.** Modified from *governance and innovation for sustainability* (Roome 2004, 277).

Roome (2004) identifies three different innovation processes – compliance, the proactive company and sustainable enterprise. A compliance driven company takes its lead on environmental performance from the regulator. Its vision on innovation is only limited to manufacturing processes, products or services and the substances.

The second position comes about in companies which have quality systems or advance internal management processes. These enable more proactive approaches because information about environmental performance is integrated into organizational routines. Products and processes are continued to be included in the innovation vision, but the proactive company takes

account of the way technologies combine with one another *and how companies can operate together in their value chains to improve environmental or social performance* (Roome 2004, 278). This second position is applicable also in NGOs innovations. Many private regulation schemes presuppose and need co-operation with companies implementing the schemes. Improvements can be more significant when companies act together and with NGOs.

The third position centers on sustainable forms of enterprise. It is about activity of enterprise and not the enterprise as a legal entity. Companies contribute to sustainable enterprise by adopting practices of corporate responsibility and by working to initiate change with other actors through multi-actor platforms. These platforms are many self and private regulation schemes and development projects (Sorsa 2011b). It is not the companies which become environmentally sustainable but the pattern of production and consumption those companies contribute to. This assumes that companies share responsibility for the sustainability of the socio-technical systems to which their products or service contribute. Companies determine the visions for the system together with the other actors who contribute to them. (Roome 2004, 278; Sorsa 2011b)

Roome's model (Roome 2004) is focused on innovations whereas Sorsa (2008a; 2008b; 2009a) develops a company's strategic model concerning legal issues categorizing strategic approaches into five positions: avoidance, compliance, prevention, advantage and transformation. The scope of actors with whom a company has connections has similarities to the Roome's model: in the transformation position the relation with stakeholders is the broadest and deepest. The focus of co-operation in regulation also broadens the compliance issues towards a proactive strategic impact on the regulatory environment.

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## APPENDIX

### The contents of GLOBALG.A.P

The GLOBALG.A.P consists of a set of normative documents. These documents include the General Regulations, the Control Points and Compliance Criteria (CPCC) Protocol and the Checklist. General regulations set out the rules by which the standard is administered. This document describes the basic steps and considerations involved for the applicant to obtain and maintain GLOBALG.A.P. certification, as well as the role of producers, GLOBALG.A.P. and certification bodies. It consists of five different parts: (i) laying out some general information explaining what GLOBALG.A.P. is, describing the certification process, training etc., (ii) the certification body rules, containing important information for certification and accreditation bodies, (iii) the producer group certification, also known as option 2 (in contrast to option 1 which is individual certification), iv) benchmarking which explains GLOBALG.A.P. certification for those rules that are found to be technically equivalent to GLOBALG.A.P., and v) training regulations important for members who want to become approved GLOBALG.A.P. trainers or already are approved trainers. ([www.GLOBALGap.org](http://www.GLOBALGap.org))

The CPCC Protocol is the standard the farmers must comply with. To verify compliance the farms are audited. The CPCC document is divided into modules listing each scope and sub-scope, the control points, the compliance criteria and the level of compliance required. The GLOBALG.A.P. standard checklist contains 41 “major musts”, 122 “minor musts” as well as 91 recommendations (“shoulds”). Traceability and food safety are covered by major must practices while “minor musts” and “should” include environmental and animal welfare issues. Control Points include the following: record keeping and internal self-assessment/internal inspection, site history and site management, workers’ health safety and welfare, waste and pollution management, recycling and re-use, environment and conservation, complaints, and traceability. Completion and verification of a checklist consisting of 254 questions is required in order to acquire GLOBALG.A.P. certification.



## 2 PROACTIVE LAW AND ALTERNATIVE DISPUTE RESOLUTION MECHANISMS

Tarja Salmi-Tolonen

*Since law is a consequence of continued human cooperation and interaction, law must be a communicative system. The rules of law do not only regulate but also create possibilities for certain activities. (Searle 1995, 27)*

*Legislative language is constituted by various kinds of acts pertaining to rights, powers, binding forces and, further, their creation, existence and expiry. The language use connected with these acts requires institutional structure and specification of the various uses. (Salmi-Tolonen 2008)*

Proactive law urges people and businesses to take initiative and seize opportunities. Keeping causes of problems from arising is self-evidently one of the measures to take to put these principles of proactive law into practice. Mere legal compliance is not enough. It is necessary to anticipate human behaviour and the circumstances and plan policies and strategies to interrupt causes and effects of unwanted incidents and be ready to palliate or minimise damages.

Competition to capture international markets has led to an unprecedented increase in the dismantling of socio-cultural and national barriers especially in the context of cooperation in international trade. Given the increase in these and similar trends we often see legislative documents being constructed, interpreted and used transgressing boundaries and legislative systems. (See generally Bhatia et al. eds. 2003). These documents governing international trade are the outcome of public and private law-making either by national parliaments at the national level, by communities of states and their harmonisation efforts, such as the EU or the United Nations or rules made by private actors, such as trade associations or professional organizations, such as chambers of commerce and their rules and codes of ethics, and naturally the parties to a contract.

Alternative methods of conflict resolution have a long history in most countries. In most countries, however, also the alternative methods are regulated by the

national public legislature at least as far as their own territory is concerned. Peaceful conflict resolution is sought after all over the world and after the introduction of the UNCITRAL Model Law on International Commercial Arbitration in 1985, a law recommended to be enacted by states, a number of developed jurisdictions adopted the model law or either reformed or amended their old laws in accordance with the model law or implemented the rules into their legislation through other instruments, such as ordinances. In Europe, *Directive 2008/52/EC* on certain aspects of mediation in civil and commercial matters came into force in May, 2011. The Directive encourages and facilitates mediation as an alternative form of resolution of cross-border disputes in the EU. The law enables and empowers private actors to choose their preferred mechanisms either by conferring rights or under the principle of the freedom to contract. But even before assessing the different criteria against which the potential conflicts are evaluated, namely, the statutory, regulatory, codes of conduct and/or fairness factors, both public and private actors should act in a way that prevents conflicts altogether or if this is not possible solved peacefully within the organization or organizations concerned.

## 2.1 INTRODUCTION

In a perfect world, there are no disputes. However, we live in the real world and have to face the realities. Even where the best of proactive and preventing measures are applied, for instance, to contracting something can go wrong: there might be a delay in delivery, the goods may be damaged or inappropriate for the intended purposes, or the terms of the contract have been given different interpretations where language allows double meaning. People fail to cooperate when they do not have a common understanding of what has been agreed on. An essential principle of proactive law and proactive contracting is to anticipate, be prepared for and take control of all such contingencies. Partners to a contract need to anticipate and manage their risks by considering what the best method for solving disputes for them concerning each contract is. The seeds for disputes as well as dispute resolution are always embedded in the contract. In this chapter, alternative dispute resolution (ADR) mechanisms will be described and their merits and disadvantages considered within the proactive law and proactive contracting frame of reference.

The highest and best dispute resolution techniques are considered to be the following: preventing problems before they have a chance to arise, managing,

controlling and solving problems before they develop into disputes, and should they nevertheless do so, then resolving them as soon as possible, when facts are still fresh and before differences of opinion have escalated into conflict (see e.g. Groton 2008, 154; Dauer 2008). Employing any of these techniques requires pre-emptive planning.

By definition proactive law is a comprehensive concept concerning civil and commercial matters which refers to any regulation measure/activity, undertaken by public or private actors, as well as its methods, instruments, and results, whose purpose is by imposing duties, conferring rights and creating competences enable and empower individuals concerned or private or public bodies in achieving their commonly defined goals. In practice, the forms this concept takes are rules, practices and/or processes (Salmi-Tolonen 2011b).

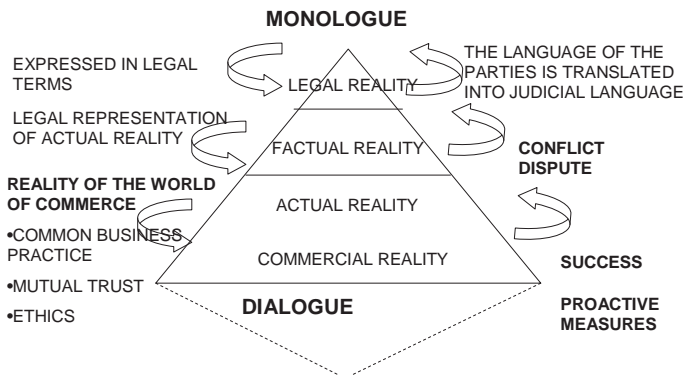
Proactive law lays emphasis on law's enabling and empowering characteristics and gives a choice to the contracting parties under the principle of the freedom of contract. Proactive contracting, again, means by definition acting in anticipation, taking advantage of all the possibilities regulation gives to enable success in planning, supporting and sustaining a contractual relationship. It is a collaborative cross-professional process to enable success *ex ante* which helps parties to reach their business goals by developing proper understanding, structures, rules, procedures and tools, and aims at identifying possible sources of disagreements and problems by bringing them out to the open before they cause damage (Salmi-Tolonen 2011a). Therefore a clear dispute resolution policy provides an important strategic advantage in identifying the sources of disagreement and dealing with them before they even arise or develop into full-fledged disputes and also when negotiating dispute resolution clauses e.g. for cross border contracts. A policy can provide a framework for the drafting of advantageous dispute resolution clauses into contracts. Well crafted dispute resolution clauses give a tactical advantage in the event that a dispute does arise. They enable the contractor to deal more effectively with disputes once they arise, thus helping anticipate and prepare for the next phase of the resolution process. It may help produce cost savings and minimise the escalation of disputes.

Based on the principle of the freedom of contract the parties to a contract may settle their disagreement the way they find best suited for them and they have agreed on. This however applies only in disputes where private law applies. Criminal matters or matters concerning public law or which have a dominant public interest can only be settled in the courts of law. The expression alternative

dispute resolution (ADR) implies that there is a default method of dispute resolution and that is to bring an action to a court of law and have the dispute settled before a public court.

In trade and business, it may not be to the interest of the parties to make their business disputes public as is the case when a conflict is solved in court. Companies have their reputation to protect; they do not want to have a reputation of being contentious contract partners. In addition, confidential issues or trade secrets may become public in course of the proceedings. Confidentiality is for many companies the principal motive for choosing ADR. Furthermore, litigation is known to take time and cost a lot of money. The case is taken from the hands of the parties and the outcome is at least to some extent unpredictable. On the other hand, the court has an obligation to resolve the dispute but there usually is a possibility to file an appeal to a higher court.

The triangle in Figure 1 describes the world of commerce (Salmi-Tolonen 2005, 60). In the reality of the world of commerce business ethics, mutual trust and common business practices are essential. The partners are initially engaged in dialogue and seek mutual success. Risks may arise but they are still avoidable, if recognized or foreseen and dealt with proactive and pre-emptive measures through dialogue between the parties to a contract. If a conflict does arise, the situation becomes more difficult; the dialogue is disrupted and gradually moves towards monologue where actual reality is taken over by factual reality and finally the legal reality. If a conflict has to be resolved in litigation, the contract of the parties is taken out of their hands and translated into a language unknown to them – the legal language, the language of judges and lawyers.



**FIGURE 1.** *Dialogue dynamics.*

Dispute prevention should start even before contract formation and be made visible in the company strategy and policy and be understood at all levels of the organization.

During sales negotiations parties express their interests and more often than not it is the mutual interest that brought the parties together in the first place. Therefore many claims are more negotiable at this stage than they would be at the later stages of the contractual relationship. One could say that at this stage parties do what they like or wish to do rather than what they should do or must do.

Should a conflict nevertheless arise the best way to handle it peacefully, is at the lowest level closest to the cause of the disagreement and before the problem becomes intractable. The best solution is not what the parties can do, namely, refer to their rights and let the law solve the problem, but what they should do to find a solution to the best interest and minimal losses for both of the parties.

## 2.2 ALTERNATIVE DISPUTE RESOLUTION – ADR

Alternative dispute resolution typically refers to processes and techniques of resolving disputes that fall outside of the judicial process – formal litigation in the courts of law. ADR is generally classified into at least four subtypes: negotiation, mediation, conciliation, and arbitration. In addition to these, especially in the US several subtypes have been created, such as collaborative law, which have been successfully used in the adversarial system in civil contexts. Adjudication and expert determination, the latter of which is a private process and best suited for disputes of valuation or purely technical nature, are also forms of ADR, to mention only a few. The ADR mechanisms are less formal ways of solving the dispute generally with the help of a third party, a neutral. Below, an example of a simple dispute resolution clause:

If a dispute arises out of or relates to this agreement the parties promise that prior to commencing court proceedings they will first endeavour in good faith to resolve the dispute by means other than litigation -- such as negotiation or by using some form of assisted dispute resolution technique.<sup>34</sup>

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34 <http://www.austlii.edu.au/au/other/alrc/publications/issues/25/app5.html>, dispute resolution services usually suggest model clauses, they can be simple or more detailed setting timelines for both the claimant and the respondent and other formal requirements such as whether the complaint should be in writing and how the respondent acknowledges the receipt of the complaint and so on.

The proactive approach implies acting in advance and seizing opportunities that best enhance success. While considering a suitable method for dispute resolution the following criteria and attributes are important:

- 1) Who controls the process? In most alternative dispute resolution techniques, the parties retain control over the process as opposed to in litigation.
- 2) How confidential is the process? In principle, all the ADR procedures are private and therefore confidential. One should point out however, that confidentiality can be understood differently in different legal cultures. In addition, in complicated cases where several witnesses are heard during the proceedings and other parties are involved, the concept of confidentiality is relative.
- 3) Is the technique expeditious? The parties will naturally want to have a satisfactory settlement as quickly as possible in order to continue their business without disruption. In most of the ADR mechanisms, the parties themselves can control the length of the proceedings by being well prepared and having a clear understanding of the relevant questions and producing documents relevant to the case.
- 4) Is the mechanism economical and who pays the costs? The question of cost is connected to the expeditiousness: the longer the proceedings the higher the costs. Time spent by the company's staff, opportunity losses, and loss of goods, among other things, should be taken into consideration while calculating the costs. In litigation, one party loses and one party wins. The losing party usually bears all costs, even those of the winner's. In ADR the costs are usually shared and each party bears its own representation costs.
- 5) If the proceedings fail, and they do not result in settlement or in some mechanisms the settlement is unsatisfactory, what are the options left for the unsatisfied party/parties in those cases? Is there a possibility for an appeal or starting litigation?
- 6) Can the parties themselves choose the neutral third party for settling the dispute? If a party nominates the neutral is he/she then the advocate of the nominator? The answer is an unequivocal no (see e.g. Kurkela and Uoti 1994). The neutral has to be completely impartial; if doubts arise, the case can be challenged.

- 7) Finally, one of the criteria is whether the parties wish to continue their contractual or business relationship. An important merit in favour of ADR is that there need not necessarily be winners or losers, which is in accordance with the spirit of proactive contracting.

In Europe, *Directive 2008/52/EC* on certain aspects of mediation in civil and commercial matters has recently been published and the substantive provisions of the Directive came into force on May 21, 2011. The purpose of the Directive is to encourage and facilitate mediation as an alternative form of resolution of cross-border disputes in the EU (with the exception of Denmark). The Directive applies when one party to the dispute is domiciled in a different member state from that of the other party and when national law requires mediation to be used in similar domestic disputes, or when a court seized of the dispute invites the parties to have recourse to mediation.

The Directive allows the parties to request that the content of a written settlement resulting from the mediation process be made enforceable except when it would be contrary to the public policy of the Member State in which the settlement was made or when the law of that State does not provide for its enforceability. The content of the settlement which has been made enforceable in one member State must be recognized and enforced in the other member States on the basis for example of *Regulation 44/2001* or *Regulation 2201/2003*.<sup>35</sup>

The Directive contains the following key elements:

- a formal recognition of the importance of mediation in ensuring access to justice
- allows courts the right to refer (“invite”) parties to mediation (or an information session on mediation if available) - without prejudice to national legislation making mediation compulsory or refusal to mediate subject to sanctions
- allowing parties to make settlements directly enforceable in the courts
- protecting mediators/mediation providers from being called as witnesses except for major public reasons or for proving terms of settlement agreements
- protecting limitation period rights where parties have opted for a mediation.

Below, the methods of ADR which are favoured in international business will be described.

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35 EU Law Blog <<http://eulaw.typepad.com/eulawblog>>

## 2.2.1 Negotiation

According to the principles of the proactive approach, the parties should aim at an early intervention and resort to pre-emptive measures before they have a full-fledged dispute in their hands. Ideally this process is cross-professional. According to the nature of the case management, sales, technical experts and legal counsels should participate. Even if agreed that the contract has been breached the contingencies may be such that it is not sensible or financially profitable to resort to a rights based approach.

The parties can choose their dispute resolution policy and agree to negotiate and arrive at an agreement where the losses are minimised for both parties by themselves. Negotiation probably is the most common method in the world of commerce, although for the reasons of confidentiality it is not a method much discussed in literature, but often referred to by business representatives when interviewed.<sup>36</sup> If, however, the negotiations are not successful, there still remain possibilities to have the disagreement solved by a neutral third party.

## 2.2.2 Mediation

### *Private mediation*

Mediation is a form of ADR that aims to assist two (or more) disputants in reaching an agreement without giving the decision making power to someone else such as a judge in litigation. Mediation differs from negotiation that a third party, a mediator is nominated to assist the parties. Mediation has a structure, timetable and dynamic which negotiation may not ordinarily have. There are professional mediators who can help the parties settle their dispute. Whether an agreement results or not, the parties themselves determine rather than accept something imposed on them by a third party. In the course of informal meetings, the mediator tries to help resolve the differences by helping the parties to identify the important issues in the dispute. It is to be noted that the mediator does not make a decision; it is up to the parties to reach an agreement. The mediator is there to help them find a solution to the problem and not to make a judgment who is right and who is wrong. Control over the outcome stays with the parties. Compared to a lawsuit, mediation is

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36 In a research project Corporate Contracting Capabilities 2006–2009, where 8 Finnish companies involved in global business were interviewed, this became obvious.



considered quick, private, fair and inexpensive. Mediation is also known to resolve disagreements without destroying the relationship between the parties.

As for confidentiality, it is provided for (Article 6) that “the admissibility of any information exchanged during the mediation, except for overriding considerations of public policy and for the purpose of implementing a settlement agreement”. It also provided that evidence otherwise admissible in judicial proceedings does not become inadmissible because it was used in mediation. In other words it is not possible to avoid disclosure of documents simply by submitting them during the mediation process.

However, mediation does not always result in a settlement. One advantage mediation has is that the parties can choose the mediator themselves unlike in litigation where it is out of the control of the parties who tries their case.

The parties can generally control the length of the mediation process. They can take as long or short that they need or want. If it is clear on the outset that a settlement is unlikely, the mediation can break off after the first meeting. On the other hand, if it seems that an agreement may be reached the parties usually wish to continue and spend time in finding the best agreement.

Mediation is a relatively inexpensive and quick method of solving disputes. There are professional mediators, often lawyers, whose fees are substantial, but the financial cost is usually less than fighting the matter in court. Usually each party will pay for their own representation at the mediation. It is up to each party to decide whether they want to engage any lawyers on their side. The mediator’s fees will normally be nominated by the mediator in advance and will usually be split equally between the parties.

The mediation only becomes binding when a formal settlement agreement is signed by all parties at the end of the mediation. Up to that moment any party can walk away and continue with other procedures, such as court action or arbitration. The advantage of mediation is that the parties know exactly what result they will have at the end of the day. It is whatever they have agreed in their settlement agreement. This is different in litigation or arbitration where the resolution of the dispute is given over to a judge or an arbitrator. Another advantage is that mediation is completely confidential. Even where a settlement is not reached and the matter proceeds to a court hearing or arbitration, no reference can be made to anything said during the unsuccessful mediation. It should nevertheless be pointed out that evidence otherwise

admissible in judicial proceedings will not become inadmissible because it was used in mediation.

Mediation is used in all areas of dispute: commercial, family, partnership, workplace, organizational, property and personal disputes, as well as national and international disputes.

### *Judicial mediation*

Civil disputes may also be settled in judicial mediation as encouraged by *Directive 2008/52/EC*. Judicial mediation is an alternative dispute resolution method in the public system. For instance in Finland, civil disputes can also be subjected to court-connected mediation. Judicial mediation can be applied to disputes that are otherwise brought before a district court (in Finland the court of first instance). The difference of opinion between the parties concerned may relate to some dispute over a contract, legacy or injury indemnification. Judicial mediation may be appropriate also in cases concerning care of a child, visiting rights or maintenance of a child.

In judicial mediation, a judge of the District Court acts as mediator. Mediation in disputes is a part of the ordinary tasks of a judge. If the case requires specific knowledge of some area, the mediator may, with the agreement of the parties, engage an assistant whose fee is paid by the parties. ([www.om.fi](http://www.om.fi))

There is a fee for judicial mediation, as for all other matters handled by a court. Mediation, however, involves lower costs for the parties than a trial. The parties pay only their own costs and are not obliged to pay the costs of the opponent. The parties can engage a legal adviser, if they see it necessary. It is also possible for a party to apply for legal aid at a legal aid office.

### *Semi-public mediation*

For consumer cases there are independent agencies in most countries to aid consumers and businesses in matters concerning consumer laws. Consumer disputes can be mediated by a consumer adviser and/or a consumer complaint board or agency. In many countries there are also consumer ombudsmen who help consumers and handle group complaints and take them before the consumer complaint board. The decisions of a dispute agency are

recommendations but non-compliance can lead to the company ending up on a black list of disreputable companies or litigation.

Managing the customer relationship is an integral part of the agreement concluded with the customer. If the consumers do not have an opportunity to complain about possible defects in the goods or services they have purchased, the company has breached the law and there may be legal consequences which can be costly and would have easily been avoided. Customer complaints must be handled appropriately. Today, it is often the customer service model that is a decisive factor when customers make their service decisions. It is therefore imperative that the service provider has a pre-emptive plan how possible contingencies will be handled.

A business must ensure that consumers are able to exercise their basic rights effectively. In addition, customers must be provided information regarding their rights, such as how to have an invoicing mistake rectified or a defective item repaired. It is essential that company employees at all levels are aware of customer's rights and can give correct information. If the sales personnel, for instance, is not aware of rules and regulations and are not aware of the company policies, customer dissatisfaction can turn into a time-consuming and costly process.

The decisions of the consumer complaint board are recommendations. If the customer is not satisfied he or she can still bring an action before a court of first instance. One of the tasks of the consumer complaint board is to give advice to the courts on consumer matters.

### 2.2.3 Conciliation

There is, on occasion, a terminological confusion between mediation and conciliation and the difference is not always clear. Conciliation is sometimes used as a blanket term that covers all mediation and facilitative and advisory dispute resolution techniques. Conciliation can be used to describe a process where the neutral takes a relatively active role, putting forward terms of settlement or an opinion on the case. However, there is no international consistency over which process, mediation or conciliation, is the more active, and mediation is increasingly being adopted as the generic term for third-party facilitation in commercial disputes.<sup>37</sup> In some industries and some jurisdictions, conciliation

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37 CEDR

is an alternative dispute resolution option in any commercial dispute. In Ireland for instance, the vast majority of conciliations arise out of contracts used in the construction industry.<sup>38</sup> The conciliators usually possess expert knowledge in the domain they are conciliating. It is a process similar to mediation where the conciliator seeks to facilitate a settlement between the parties. It can be said that conciliation is rarely availed, although in some countries it is used in respect of construction disputes. Under the industry defined procedures for conciliation, the conciliator is obliged to issue a recommendation setting out the basis on which he or she believes the dispute should be solved, if the parties fail to reach settlement. A conciliator no more than a mediator possesses any enforcing powers.

If the parties reach settlement, the settlement is put in writing and signed by the parties. The settlement then becomes final and binding. If the settlement is not reached and the conciliator issues a recommendation, the recommendation will become final and binding between the parties unless one of them rejects the recommendation within a specified number of days. The conciliation procedure is confidential, and if the conciliator's recommendation is rejected, the entire procedure is to be regarded confidential and neither party can refer to anything that occurred in the process or call the conciliator as a witness in any proceedings.

In theory, conciliation can be availed of in relation to almost any dispute, but mediation is often considered more appropriate for sensitive issues such as family matters. But as was mentioned above in practice conciliation is seldom used apart from the construction industry in some countries e.g. Ireland. In Finland, again, arbitration is often used in construction contract probably because the standard terms (YSE 98) drafted by the construction industry contains an arbitration clause.

The practice is that each party bears its own costs and pays half of the conciliators' fees irrespective of the outcome. Compared with litigation or arbitration, the cost is relatively small.

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38 [www.arbitration.ie](http://www.arbitration.ie)

## 2.2.4 Arbitration

Arbitration is a form of ADR popular in commerce and especially in international transactions. Companies prefer to use international arbitration rather than transnational litigation as a means of resolving cross border disputes.<sup>39</sup> This method of ADR differs from the ones discussed above in that it bears more similarities to court litigation than the others. Also there is an international model law adhered to by many countries developed and developing. Most countries have arbitration acts and a number of them are based on the Model Law for protecting of the arbitral proceedings in domestic cases.

The General Assembly of the United Nations adopted a Resolution approving the Model Law on International Commercial Arbitration on December 11, 1985 (amended in 2006). The drafting of the model law was an effort to improve the overall framework of international commercial arbitration and to secure enactment by States throughout the world of modern arbitration legislation based on the model law. A number of countries have adopted The United Nations Model Law, the UNCITRAL Model Law as such (e.g. Denmark, Germany, Norway and Russia) or as the basis of their domestic arbitration acts (e.g. Finland and Sweden). However, some states where many important arbitration proceedings take place (e.g. England, France, the Netherlands and Switzerland) have not enacted arbitration laws based on the Model Law.

Selecting which rules to use has different consequences as they may be more suitable for a certain type of industry while not as useful for others. However, some institutions provide different rules on different industries. Nevertheless some of these seats are specialised for certain types of disputes and therefore choosing which rules to use should always be given careful consideration.

International arbitration is a consensual method of solving disputes away from litigation in national courts. This creates opportunities for the informed who are equipped with knowledge, tools and tactics to conduct international arbitration and to manage their risks and cross border disputes effectively.

The advantages of international arbitration are considered to be the flexibility of procedure, the enforceability of the awards, the privacy afforded by the process and the ability of the parties to select the arbitrators. These are qualifications

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39 See e.g. Price Waterhouse Coopers' study on the use of international arbitration 2006 International arbitration: Corporate attitudes and practices.

also attributed to other ADR methods. One difference is that the outcome of the arbitration proceedings the judgment, the award as it is called, is enforceable. It is thus binding. In the studies, expenses and the length of time to resolve disputes are the two most commonly cited disadvantages (see e.g. Kurkela and Uoti 1994). However, a clear dispute resolution policy provides an important strategic advantage when negotiating dispute resolution clauses for cross border contracts.

Arbitration proceedings are legal proceedings and certain very fundamental rules and principles are to be met. These may best be described as *due process* principles. Should these be breached the outcome will most likely be invalid. The control of *due process* and legal rules including *ordre public* is subject to post-control by the courts (Kurkela and Uoti 1994). Arbitration clauses included in contracts determine the form and legal basis of the arbitration process and shape the way in which proceedings are conducted. Well-crafted clauses can enable a party to include beneficial terms such as the choice of seat and the composition of the tribunal. However, it requires knowledge of the arbitration process to ensure the choices made are advantageous. Therefore, although many industrial authorities include an arbitration clause in their model contracts, it is imperative that the companies who append these standard terms to their contracts make absolutely sure that they are well suited in their line of business. Otherwise it may come as a surprise that the choice has been made by other authorities.

Arbitration is similar to court litigation in that it usually involves pleadings and a full hearing although the Model Law, as well as most national laws, does not contain any detailed rules on evidence in arbitration (Möller 2010). Another similarity is that the arbitrator finds the solution the way the judge does in litigation rather than helps the parties as is the case in mediation.

#### *Types of arbitration: Institutional and ad hoc arbitration*

There are basically two types of arbitration: institutional arbitration and *ad hoc* arbitration. Institutional arbitration is conducted under arbitration rules of an arbitration centre or arbitration institute and administered by it. Almost every country has its own institute of chartered arbitrators: The purpose of the institutes is to be the authority on the regulation, administration, training and promotion of arbitration. In many countries an arbitration institute is set up under the Central Chamber of Commerce. Famous institutions and

much used in Europe are the International Court of Arbitration, the ICC in Paris, The Court of International Arbitration and the Chartered Institute of Arbitrators in London (UK), and Arbitration Institute Stockholm Chamber of Commerce, and in the US the National Arbitration Forum, to name but a few. There are also several arbitration centres in South-East Asia (e.g. Singapore, Brunei) and in China (e.g. CIETAC in Beijing, Shanghai and HKIAC in Hong Kong). The choice of the arbitration seat is very important and careful consideration should be given to it as well as the language of arbitration. They both have also direct affect on the cost of arbitration. In cross border contracts English is very often the language agreed also in arbitration. Should the parties choose more than one language the case may become complicated. There will be translation costs and interpretation fees as well as interpretation issues may arise from the different language versions.

Arbitration is a process whereby parties agree to refer disputes between them for resolution to an independent third party known as the Arbitrator. The Arbitrator works to rules agreed between the parties or, if no such rules are agreed, as laid down by the Arbitration Acts. The Arbitrator is usually an expert in the subject matter of the dispute. A major advantage is that it is a confidential and private process. Those present during the proceedings, even a possible secretary the arbitrator has appointed, will have to be accepted by the parties.

Arbitration is generally given three attributes: effective, expeditious and economical compared to litigation. It can be effective in the sense that the arbitrator is appointed by the parties and usually an expert in the line of business or industry in question. The mechanism is set out in an arbitration clause in the contract. The parties to a contract may also mention the arbitrator by name in the contract. Although most arbitrators today are legal professionals who have experience in disputes in the field they could be experts in, say, certain kind of technology the dispute is about and be well versed and experienced in arbitration. Arbitration can take from a day or up to a year in complicated cases. It has been noted that the length of the process is connected to the parties' presentation of the cases and sometimes unfocused requests for disclosure of documents and unnecessary witness and expert evidence.<sup>40</sup> It is therefore important to work proactively and prepare the case well. Sometimes the Arbitrator sets a date by which the documents they see necessary be sent to the Arbitrator and no more documents after that are accepted.<sup>41</sup>

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40 ICC Publication 843 – Techniques for Controlling Time and Costs in Arbitration.

41 Personal Communication, Arbitrator interviews for the project International Arbitration in Action (forthcoming).

It is generally thought that arbitration costs less than litigation but in some cases that may be a myth. It is clear that the cost is directly dependent on the length of the proceedings and as mentioned above the parties can proactively shorten the proceedings. The ICC Commission on Arbitration reports that costs borne by the parties to present their cases including lawyers' fees and expenses, expenses related to witness and expert evidence, and other costs incurred by the parties constitutes 82% of the costs; Arbitrators' fees and expenses 16%; Administrative expenses of ICC 2%. It is generally thought that it is the arbitrators' fees that are the biggest expense, but this survey shows that this is not so in the cases arbitrated under the ICC rules. In general, the advantages of international arbitration are considered to outweigh the disadvantages.<sup>42</sup>

Arbitration centres usually recommend a standard arbitration clause which should be simple and clearly drafted to avoid uncertainty and disputes as to their meaning and effect. Below the ICC's standard clause:

All disputes arising out of or in connection with the present contract shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules. (ICC Model arbitration clause in English)<sup>43</sup>

In addition to the standard clause, the place of arbitration, the language of arbitration and the rules of law governing the contract should be specified in a separate sentence. One should be cautious not to add further provisions to the arbitration clause relating to the procedure for the arbitration. It is however noted that multi-party and multi-contract transactions may require specific additional provisions.

For small disputes a three-member tribunal may be too expensive and consideration should be given to wording of the arbitration clause so that it gives the parties a choice (e.g. one or more). If the parties wish the arbitration institute to select and appoint all members of the arbitration tribunal then the following wording can be used "All arbitrators shall be selected and appointed by ...".

Fast-track procedure, also known as expedited procedure, is in some cases possible and careful consideration should be given to setting out such

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42 See e.g. Kurkela and Uoti (1994).

43 ICC Rules of Arbitration, ICC Publication 846.



procedures in the arbitration clause. Fast-track procedures are designed to enable an arbitration to proceed quickly, given the specific nature of the contract and disputes that they are likely to arise. However, it is difficult to predict with any degree of certainty what kinds of disputes may arise. Once the dispute has arisen the parties can at the time agree on a fast-track procedure, if they see it appropriate.

### *Ad hoc arbitration*

*Ad hoc* arbitration refers to self-administered arbitral proceedings where the parties usually adopt well-crafted arbitration rules such as the UNCITRAL Model law instead of the rules of an arbitration institute. Properly structured *ad hoc* arbitration should be less expensive than institutional arbitration as the parties there will be no administrative fees to an arbitration centre. *Ad hoc* arbitration may be better suited in small claims. This method places more of a burden on the arbitrator(s) and to the lesser extent to the parties to organise the proceedings in an effective manner. In a recent survey, experienced arbitrators said when interviewed that they are usually involved in *ad hoc* arbitration and are the sole arbitrators.<sup>44</sup> This is no doubt the consequence of the parties wanting to cut expenses and also where an arbitrator is well known and has good reputation in a certain line of industry. Parties have been reported to place the arbitrator very high on their list of priorities in arbitration proceedings.<sup>45</sup> The qualities the companies appreciate in arbitrators are their professional qualifications and experience as lawyers and as arbitrators, expertise and experience in the industry or business where the dispute has arisen, and more importantly the personality of the arbitrator.<sup>46</sup>

One important point to bear in mind is that as arbitration is based on the consent of the parties, arbitrators generally have no power to make orders or decisions affecting non-parties to the arbitration agreement. Furthermore, in contrast to courts, they generally do not have power to compel witnesses to testify or produce documents, to require third parties to participate in arbitration proceedings, or to make awards requiring a third party to do or to refrain from doing something.

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44 Salmi-Tolonen (2009) "Arbitrator profile revisited" a presentation in a colloquium organised by *International Commercial Arbitration Practice: A Discourse Analytical Study* Project, funded by RGC CERG (CityU 1501/06H) (forthcoming).

45 See e.g. PriceWaterhouseCoopers survey 2008.

46 cf. e.g. Inkeroinen 2007, 85 and Salmi-Tolonen (forthcoming) on arbitrator profiles.

The arbitration award (decision) is usually final and not subject to be reviewed on its merits. It can be challenged only in limited circumstances, for instance, if the arbitrator has made an error of law. Often the challenge concerns the partiality of the arbitrator but the challenges have seldom been successful after the award<sup>47</sup>. The parties have a chance to accept or dismiss the arbitrators on justified grounds before the proceedings start

### 2.2.5 Online dispute resolution – ODR

The extraordinary growth of online commerce and online transactions and consequently generated a number of disputes. But internet also provides resources for solving these conflicts and favours the development of procedures to resolve disputes totally, or partly, online. Online dispute resolution is a mechanism of ADR through another medium and in virtual environment. The principles are similar to the offline ADR methods. The online dispute resolution method or medium, widely used in the United States but in the last few years also in Europe, is known under the acronym of ‘ODR’ (Online Disputes Resolution). The new models of online resolution of disputes have had wide diffusion in all sectors and particularly in the virtual market.

Today, in fact, there are several ODR services offered all over the world. One example is Square Trade – an American company that manages the procedures of resolution of the quarrels on behalf of the well-known internet company eBay. Square Trade offers two services: a free web-based forum which allows users to attempt to resolve their differences by themselves or, if necessary, the use of a professional mediator. All eBay buyers and sellers can use this online dispute resolution service. It is free to file a complaint. Square Trade will then contact and encourage the other party to respond to the claimant’s case. The claimant and the respondent can then try and settle their dispute through Square Trade’s free web-based process and technology. eBay’s webpage informs that a significant number of complaints are directly resolved in this way.<sup>48</sup> The service is free, but if assistance of a professional mediator is requested, there is a nominal fee. eBay advertises that they subsidize the rest of the cost. This eBay example is in fact a paragon example of a company’s proactive policy planning in its own line of business.

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47 p.c. arbitrator interviews

48 <http://pages.ebay.com/services/buyandsell/disputeres.html>

The online method has proved to cater especially the needs of medium-small disputes, such as those in B2B (business to business) and B2C (business to consumer) transactions over the Internet. As e-commerce transactions are becoming more and more frequent, it has been noted that where there are transactions on or offline there are potential disputes (Hart 1999). The growth of online business greatly depends on the possibility to provide consumers with easy access to justice also taking advantage of the opportunities provided by the online environment. In the US there also seems to be a growing market for settling disputes between schools and parents as well as public service providers and citizens.

Besides being the easiest way of resolving problems deriving from transactions generated on the internet, ODR is also becoming popular to resolve off-line disputes. The reason is that the online dispute resolution service is simple and easy to carry out as it allows users to cancel time and space barriers, offering them the possibility to communicate easily. All these are environments where both consumers and businesses need faster and more reliable instruments to solve disputes. Some organizations who offer off-line mediation and arbitration also offer online services.<sup>49</sup>

The latest versions of online mediation enable the mediator and all other mediation parties to use their computers, as well as audio and visual communication means and a broadband Internet connection to request and participate seamlessly in live, synchronous audio/visual online mediation proceedings. The proceedings are carried out before professional mediators who are 'on duty' during normal business hours. Upon approval of the request from the parties, the service provider notifies the on duty mediator, who promptly informs the mediation parties of the imminent synchronous audio/visual online session. If an agreement is reached, the mediator sends a draft of the mediation agreement online. This can be examined on the spot by the parties, who can thus edit it live. Thus a final mediation agreement is stipulated and signed. Thanks to electronic signatures, there is no need to print and exchange documents by fax. This last operation is necessary to make the online agreement binding, thus conferring it the nature of a real contract enforceable by law. (Gotti 2011)

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49 <http://www.cedr.com/solve/mediation/>

## 2.3 SUMMARY

### 2.3.1 Confidentiality and Trust

In ADR, whether online or offline, trust is one of the key issues. In face-to-face mediation this trust is established during the mediation sessions. Where online mediation is concerned, it seems far more difficult, though no less important, to establish and maintain trust. In the online mediation process, parties often do not know each other and do not have an ongoing virtual or real-time relationship of any kind. The parties are involved in an electronic commerce transaction usually in a consumer/merchant relationship. In most cases these parties have not had dealing with one another before the dispute arises.

There are several trust-related problems where online transactions and online mediation is concerned. First of all, the identity of the person is not always clear. Electronic signatures play an important role in online transactions as well as in online dispute resolution.

Closely linked with the problem of identity on the Internet are the problems of data security and confidentiality. Encryption ensures the security. EU Data Protection Directive (also known as Directive 95/46/EC) is a directive adopted by the European Union designed to protect the privacy and protection of all personal data collected for or about citizens of the EU, especially as it relates to processing, using, or exchanging such data. Directive 95/46/EC encompasses all key elements from article 8 of the European Convention on Human Rights. The Directive states that its intention is to respect the rights of privacy in personal and family life, as well as in the home and in personal correspondence. The Directive is based on the 1980 OECD “Recommendations of the Council Concerning Guidelines Governing the Protection of Privacy and Trans-Border Flows of Personal Data.” The member states have transposed the provisions into their domestic legislation (in Finland Data Protection Act came into force in 1999).

### 2.3.2 Compliance and Enforceability

An important aspect of ADR in general, is the fact that it always takes place “in the shadow of the law” (Mnookin and Kornhauser 1979). This means that the disputing parties that are trying to find a peaceful solution through alternative dispute resolution are aware of the legal rules governing the area of their dispute. The outcome that the law will impose, if no agreement is

reached, gives each party a reasonably good idea of its bargaining position. However, a point to consider is that since in general the ADR processes are confidential there are no precedents although some dispute resolution centres publish summaries of the cases solved under their rules. Thus parties will take the law into consideration when setting out a strategy in the ADR procedure (Cooter et al. 1982). For e-disputes there is the problem that it is not always obvious which law applies, especially with cross-border e-disputes. However, managers can use a variety of legal tools to create value and manage risk (Bagley, 2000) and to lower costs or enhance differentiation (Siedel, 2002). Legally astute managers and councils can employ the law to the company's advantage while planning the dispute resolution strategy and not merely comply with the law (Bagley 2005).

Compliance and enforceability are issues high on the list of priorities of the parties who have their case mediated on or offline. In offline mediation compliance is usually high because of the "shadow of the applicable law" and the enforceability of settlements and arbitral awards. It has been reported that in eBay disputes the compliance has been high because the vendors did not want to jeopardise their position in the eBay or in the virtual marketplace community (Katsh and Rifkind 2000, 5 and 17).

**TABLE I.** *Summary of dispute resolution mechanisms.*

	COMMERCIAL REALITY	COMMERCIAL REALITY	ACTUAL REALITY	FACTUAL REALITY	LEGAL REALITY
MEASURES	PROACTIVE	DISPUTE	FACILITATED	BINDING	BINDING
MECHANISMS		CONTROL	RESOLUTION	RESOLUTION	RESOLUTION
DEGREE OF CONTROL	MAXIMUM	VERY GOOD	VERY GOOD	GOOD	POOR/NONE
DIALOGUE VS MONOLOGUE	DIALOGUE	DIALOGUE	DIALOGUE	DIALOGUE	MONOLOGUE
PUBLIC					<b>LITIGATION</b>
LEGAL					
ENFORCEABLE					
POSSIBILITY TO APPEAL					
PRIVATE				<b>ARBITRATION</b>	
CROSSPROFESSIONAL					
CONFIDENTIAL					
ENFORCEABLE					
PRIVATE			<b>MEDIATION</b>		
CROSSPROFESSIONAL					
CONFIDENTIAL					
ENFORCEABLE					
POSSIBILITY TO TAKE ACTION					
PRIVATE			<b>CONCILIATION</b>		
CROSSPROFESSIONAL					
CONFIDENTIAL					
ENFORCEABLE					
POSSIBILITY TO TAKE ACTION					
PRIVATE		<b>NEGOTIATION</b>			
CROSSPROFESSIONAL					
CONFIDENTIAL					
ENFORCEABLE					
POSSIBILITY TO TAKE ACTION					
PRIVATE	<b>PROACTIVE PLANNING RISK ALLOCATION RISK AVOIDANCE</b>				
CROSSPROFESSIONAL					
CONFIDENTIAL					
ENFORCEABLE					
POSSIBILITY TO TAKE ACTION					
	PRIMARY	SECONDARY	TERTIARY	TERTIARY	

----->ESCALATING TIME AND COST

Table 1 above summarises the ADR mechanisms and their qualifications, pros and cons that have been discussed above. In the table, time and cost escalate from left to right whereas the degree of control and freedom of the parties decreases from bottom to top and at the same time distress and the severity of the conflict increases from bottom to top. In contrast the enforceability of the outcome, the settlement or decision (arbitral award or judgment) increases from left to right. It is obvious that the qualifications, pros and cons, should be given careful consideration when planning the dispute resolution strategy. (See also Groton 2008, 259)

Considering the parameters in Table 1, it is clear that the possibilities of proactive measures are the highest on the left hand side bottom and the possibilities diminish when moving from left to right and from bottom to top. In Edward Dauer's (2008, 25) terms primary prevention namely "keep the cause of the problem from arising" is still possible in the situation on the left hand side and moving towards right to secondary prevention "interrupt the cause and effect" and further to tertiary prevention "palliate or minimise the damage".

### 2.3.3 Conclusions

This section embedded considerations of dispute resolution techniques into the framework of proactive law and proactive contracting and explained the pros and cons of these mechanisms as tools for managing disputes proactively. Managing disputes and choosing the mechanisms for solving them is closely connected to a company's risk management strategies (see Part III, Chapter 5) and the organizational policy in general. Dispute resolution strategy to be effective should not stay at the managerial level, but it should be made visible at all levels in the company and its personnel at different phases of the transactions all the way down to the shop floor, because it is there that in many cases the customers make their decisions and it is there that the experiences of satisfaction or dissatisfaction are generated. A clear dispute resolution policy provides an important strategic advantage in identifying the sources of disagreement and dealing with them before they even arise or develop into full-fledged disputes and also when negotiating dispute resolution clauses.

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## Useful websites:

[www.adrcenter.com/jamsinternational/civil-justice/Survey\\_Data\\_Report.pdf](http://www.adrcenter.com/jamsinternational/civil-justice/Survey_Data_Report.pdf)

[www.hg.org/arbitration-mediation-associations-europe.html](http://www.hg.org/arbitration-mediation-associations-europe.html)

<http://www.cedr.com/solve/mediation/>

<http://www.mbc.com/ecommerce/legis/congress.html#hb1714>



PART II

PROACTIVE APPROACHES TO LAW



# THE DEVELOPMENT AND HISTORY OF A PROACTIVE APPROACH TO LAW

*Gerlinde Berger-Walliser*

Though definitions of what characterizes the law vary substantially, a common underlying concept of the nature of law seems to be that law is a set of rules initially made to guide human conduct, imposed upon, and enforced among, the members of a given community of people or a nation state. This, or similar definitions, express a view of the law, according to which it is the legislator's task to interpret society's collective interests, and to define in legal rules what is forbidden and what is socially acceptable, and therefore lawful. Consequently, in most countries – at least in those of the Western world – a legal system has been set up, to enforce these legal rules with the help of legal professionals (judges, arbitrators, prosecutors, lawyers, in-house-counsels). Usually it is a public court system which enforces the law.

More recently alternative, private dispute resolution systems such as arbitration are increasingly taking over this role, but still ensuring that people (or companies) behave according to the rules, and to punish those who do not obey the law. The enforceability is a fundamental feature of the *ius cogens* (compelling law). Though, at first sight, this definition of the law seems mainly to reflect the functioning of criminal law, it also expresses the underlying principle in private or business law. For example: if a supplier does not deliver in time, or the quality of the goods or services delivered do not correspond to the buyers expectations, the contract typically provides some form of penalties or liquidated damages. The law (written or unwritten) may provide exceptions under which the delay or the poor quality will be excused, because the society considers that, for example, the delay in delivery was not the suppliers fault, or from an objective point of view the goods met sufficient quality standards. If there are no valid excuses, the suppliers will have to bear the consequences of their failure, that is reproduce perfect goods and deliver a second time, and pay monetary damages for the economic loss the business partner has suffered due to the late delivery

or poor performance. Typically the decision about these legal consequences of the supplier's misconduct will be delegated to a court or an arbitrator, and the interests of the companies involved will be represented by lawyers.

However, the lawsuit is not the ultimate goal, but compliance with the law on a voluntary basis is the underlying principle of a functioning legal system. Without a general acceptance of the public that the law has to be respected and the lawsuit is the *ultima ratio* the effectiveness of a law would be irremediably compromised (Proactive Law Opinion<sup>50</sup>). There is a growing awareness that in addition to being equitable or "just", the law must be comprehensible, accessible, acceptable, and enforceable (op.cit. at 2.4). In the EU, the needs for better law making have long been promoted and argued for as main policy objectives (op.cit. at 1.3).

But in today's society this is not enough. The traditional legal system as presented above is (mainly) backwards oriented. Even if governments or industries develop laws and regulations in order to influence the future, often these changes or new legal developments take place in reaction to negative developments in society, and evolve around shortcomings and failures of the existing legal system. The long and time-consuming legislative process makes it difficult to adapt to the quickly changing social and technical environment.

Court decisions sanction failures, respond to deficits, disputes, missed deadlines and breaches, seeking to resolve and remedy (op.cit. at 1.3). But not only law making and the judiciary, also private legal relationships such as contracts suffer from this failure and litigation orientation. Instead of promoting good behaviour they provide penalties or liquidated damages, damages, dispute resolution clauses, almost assuming that something will go wrong. Ultimately this approach leads to litigation, loss, broken relationships, costs, but also the loss of opportunities, which cannot be measured in money alone (op.cit. 1.3). What is needed is a legal system and legal instruments that promote good behaviour, quickly adapt to new developments, avoid disputes, solve problems, foster sustainable private and business relationship, enhance collaboration, and ultimately create value, instead of causing costs and destroying relationships in the broadest sense of the word.

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50 See generally Opinion of the European Economic and Social Committee on "The proactive law approach: a further step towards better regulation at EU level", 2009 Official. J. Eur. Union, July 28, 2009, at C 175/26, § 2.2, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:175:0026:0033:EN:PDF>.

This is where *proactive law* comes into play. Proactive law challenges the traditional backwards and failure oriented approach to law and urges a paradigm shift (Barton 2008). The word “proactive” implies action and a forward-looking, *ex ante* focus. Being proactive is the opposite of being reactive or passive. It involves acting in anticipation, taking control, and self-initiation, instead of reacting to failures and shortcoming as traditional law usually does (Siedel & Haapio 2010). Proactive law tries to develop concepts, theories and tools to use legal instruments proactively in order to achieve the goals enumerated above. This includes drafting laws that encourage good behaviour, self-regulation, agile contracts that adapt to changing situations and help to create trust among business partners, early-warning and dispute prevention mechanisms, and cross-professional collaboration for better understanding of business needs.

This chapter describes the basic development of proactive approach to law, its history and origins in *preventive law*,<sup>51</sup> and correlation with other emerging alternative legal approaches, which Susan Daicoff (2005) in her extensive study on the law as a healing profession calls the *comprehensive law movement* and in how far it differs from the latter. The following chapters will provide the concepts, theory and practical tools for students to practice and use, what we call, proactive law.

Because the perspective and necessary knowledge may differ for law and business students, this part will be divided into two: “Proactive law for lawyers” addresses more specifically the law students, providing them with the necessary, knowledge and skills for thinking proactively and developing capacities to provide proactive legal services. The goal is to turn them into “multi-dimensional lawyers” (Barton 2008), and ultimately enable them to eventually redirect some structures of the legal system itself. They will learn basic concepts of management in order to enable them to work in a cross-professional and multidisciplinary manner, understand their client’s needs, conduct proactive legal audits and make legal risk assessment. They will learn proactive legal techniques and tools, so that clients will be better and more efficiently served.

The second part addresses business students – the future users of proactive law and possible clients. Important features of proactive law are cross-professional collaboration, and, to a certain degree, the ability for managers and subject-matter experts such as engineers to take “self-care” measures. Both imply a

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51 The preventive law movement originated in the United States of Americas in the mid-fifties of the 20th century, see Brown, Louis M. (1950) Preventive Law.

basic understanding of management and the legal environment, in addition to specific tools and knowledge related to the strategic and operational use of proactive law in management practice.

## 1.1 HISTORY AND DEVELOPMENT OF THE PROACTIVE LAW MOVEMENT

The approach specifically called proactive law emerged in Finland in the late 1990s. Initially the focus of the proactive legal approach was on contract law. The first publication relating to the approach was a paper entitled “Quality Improvement through Proactive Contracting” that Helena Haapio presented at the Annual Quality Congress of the American Society for Quality in Philadelphia in 1998.<sup>52</sup> This paper was followed by a series of publications and the first proactive law conference, which was held in Helsinki in 2003.<sup>53</sup>

A central figure in the field is the Nordic School of Proactive Law, a network of researchers and practitioners from Denmark, Finland, Iceland, Norway, and Sweden, each of whom has an interest in proactive law. The Nordic School was instrumental in the creation of the ProActive ThinkTank, led by a core team from Denmark, Finland, France, the Netherlands, and the United Kingdom (Siedel & Haapio 2010).<sup>54</sup> The mission of the ThinkTank is to provide a forum for business leaders, lawyers, academics, and other professionals to discuss, develop, and promote the proactive management of relationships, contracts, and risks and the prevention of legal uncertainties and disputes.<sup>55</sup> Among the publications following conferences organized by the Nordic School are three English language books, *A Proactive Approach* (Wahlgren ed. 2006), *Corporate*

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52 The paper was also published as Haapio, Helena, Preventive Lawyering in International Sales – Using Contract Reviews to Integrate Preventive Law, Risk Management, and Quality, *Preventive Law Reporter*, Winter 1997/1998, at 16. The two sessions where the paper was presented were graphically recorded by Annika Varjonen. The graphical notes (“visualizations”) are on file with the authors.

53 Selected conference papers were published in the Summer 2003 issue of the *Preventive Law Reporter*.

54 See also Welcome to the website of the Nordic School of Proactive Law, Nordic School of Proactive Law, <http://www.proactivelaw.org> (last visited Oct. 25, 2010); Proactive ThinkTank, Nordic School of Proactive Law, <http://www.proactivethinktank.com> (last visited Oct. 25, 2010); ProActive Think Tank Home Page, International Association for Contact and Commercial Management, <http://www.iaccm.com/proactive> (last visited Oct. 25, 2010).

55 ProActive ThinkTank Mission Statement, Nordic School of Proactive Law, <http://www.juridicum.su.se/proactivelaw/main/thinktank/missionstatement.pdf> (last visited Oct. 25, 2010).



*Contracting Capabilities* (Nystén-Haarala ed. 2008),<sup>56</sup> and *A Proactive Approach to Contracting and Law* (Haapio ed. 2008). Some of the early work of the Nordic School is available in Finnish or Swedish only. (Pohjonen ed. 2002; Pohjonen ed. 2005).

After the first developments in the Nordic countries, the proactive approach started to awaken interest outside Scandinavia, first in Europe and later in other countries, leading to conferences<sup>57</sup> and publications<sup>58</sup> on a broader scale. Through these and the International Association for Contract and Commercial Management (IACCM), information about the approach reached pioneers of Law and Strategy and Law and Competitive Advantage – emerging fields in the United States. This expanded the already existing close collaboration between the promoters of preventive law and proactive law to new fields e.g. proactive contract management, or the development of a proactive legal approach in the training of law students in the Netherlands, and led to the first attempts to trace the history of these parallel developments and to merge their common themes (Siedel & Haapio 2010, 644, 667–668).<sup>59</sup>

The importance of the proactive law approach was recently recognized in the European Union, in the Opinion of the European Economic and Social Committee (EESC) on “The proactive law approach: a further step towards better regulation at EU level”, published on July 28, 2009 in the *Official Journal of the European Union* in all official EU languages.<sup>60</sup>

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56 The publication contains a collection of academic papers presented at the third Proactive Law Conference held on June 13–16, 2007, under the title “Commercial Contracting for Strategic Advantage: Potential and Prospects” in Turku, Finland.

57 See Lexpert, Public Courses and Workshops, <http://www.lexpert.com/en/encourses.htm> (last visited Dec. 9, 2010) (listing various conferences and workshops that had material discussing the proactive approach).

58 E.g. Barton, Thomas D. (2009) Preventive Law and Problem Solving: Lawyering for the Future.

59 Siedel & Haapio apply concepts from these movements to the contracting process and illustrating opportunities to create new value and innovate in areas often neglected by managers); see also Siedel, George J. & Haapio, Helena (2011) Proactive Law for Managers: a Hidden Source of Competitive Advantage.

60 See Sepi, Mario & Westlake, Martin, Opinion of the European Economic and Social Committee on “The proactive law approach: a further step towards better regulation at EU level”, 2009 Official. J. Eur. Union, July 28, 2009, at C 175/26, § 4.2, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:175:0026:0033:EN:PDF>.

### 1.1.1 Preventive Law

The idea of an *ex ante* view or proactivity of law is not new in itself. It has been known for years that the earlier a dispute or a potential dispute is addressed, the better the chances of a fair, just and prompt solution. In the context of practising law, the idea of prevention was first introduced by Louis M. Brown, himself an experienced practitioner as well as a law professor. In his ground-laying treatise *Preventive Law*<sup>61</sup> published in 1950, he states a simple but profound truth that has not lost any of its value. Indeed, many attorneys and in-house-counsels actually act according to this motto: “It usually costs less to avoid getting into trouble than to pay for getting out of trouble.” (Brown 1950) Louis M. Brown did not *invent* preventive law. The contribution of Louis M. Brown and other scholars in the field of preventive law lies in identifying preventive law with its own name, organizing it into a distinctive way of thinking, developing concepts, if not a comprehensive general theory of preventive law (Dauer 2008). By doing so they made preventive law visible and recognizable for people with a similar mind-set. They have created awareness, which is necessary to change people’s mind-set in order to use the law according to business goals, to become more creative and preventive – better lawyers.

In order to explain how far the preventive law approach is different from traditional law Dean emeritus Edward Dauer gives the following example:

*Suppose a mature gentleman comes to see a lawyer about issuing some new shares of stock in the family corporation to his son-in-law. It turns out that the amount of stock involved would allow the son-in-law to exercise some influence over the direction of the business. In discussing the client’s intentions, the lawyer realizes there are numerous risks the client may not have considered. Any competent lawyer would investigate the statutory, regulatory, and tax liability implications of the transaction, as well as issues of voting control, percentage ownership, and buy-sell agreements. Preventive law would take the additional steps of anticipating and preempting opportunities for conflict, dashed hopes, unfulfilled assumptions and damaged relationships. If, for example, the client and his son-in-law fail to get along after the stock is issued, their disagreements, frustrated expectations, and conflicting interests may result in shareholder deadlock or*

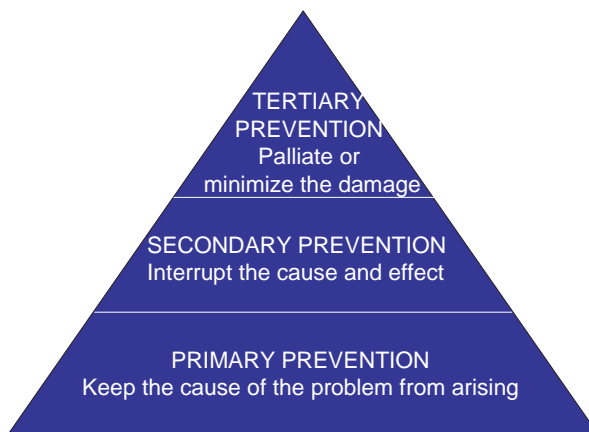
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61 It was the famous legal theorist Hans Kelsen who pointed out to Louis Brown that the term preventive law is not correct. It is not the law which is preventive but the competences of using the law by a legal professional that are preventive.

*even civil litigation, impacting the family as well as the business.* (Cited in Daicoff 2005).

Discussed more in detail elsewhere in this part of the book, Dauer identifies four core principles of preventive law:

- 1) Predicting human behaviour: As the illustrating example shows, a lawyer practising preventive law tries to predict human behaviour. He or she will search for a legal solution, which takes into account what the people will do, and by doing so anticipate and prevent litigation. Traditional law tries to predict what a court will decide. Insofar traditional law also seems to be preventive, but – as the example shows – might prevent losing in court, but still not achieve what the people really need. It remains backwards looking, failure and litigation oriented and does not improve personal or business relationships, which is essential for preventive law.
- 2) The components of conflict management: Preventive law is based on the assumption that the most successful medical treatment is prevention, and seeks to transfer this assumption from the medical to the legal context (Mahler 2008, 63). Principle 2 sets forth a three-step strategy for managing legal risk, illustrated in the figure below.



**FIGURE 1.** *A three-step strategy for managing legal risks. Dauer 2008, 25, figure adapted from Haapio 2008, 117.*

- 3) Embrace risk: This third principle, which is nothing surprising for managers, but unusual for lawyers, means to deliberately embrace some risk as a way of reducing overall risk, rather than try to drive one element of risk to zero.
- 4) Make preventive legal services available to clients: Lawyers must participate with others in multi-disciplinary teams in the planning of clients' ventures. While the first three principles predominantly ask for a change in the mind-set of lawyers, this fourth principle is oriented towards the client – the business or a private person. Not only lawyers need to become more prevention-oriented, but clients need to bring in lawyers early enough, so that they can detect legal risk and prevent harm from occurring and engage in interdisciplinary collaboration, otherwise even the best preventive lawyer may not be of help.

To these principles of preventive law, which all have influenced and are still valid for the proactive law movement, one needs to add other “vectors”, which, partially as a response to dissatisfaction with the traditional legal system, approach law in a more comprehensive, integrated, humanistic, interdisciplinary, restorative way, Susan Daicoff (2006) calls the comprehensive law movement. Some of these alternative approaches or processes are also reflected in proactive law, such as collaborative law, restorative justice, procedural justice, transformative mediation, therapeutic jurisprudence, holistic justice, creative problem solving. A common feature to all these different forms of comprehensive legal approaches, which is also essential to proactive law, is that they seek to optimize human wellbeing and consider “extra-legal factors” (Daicoff 2009).

*All of the vectors seek to resolve the legal dispute or matter in a way that prevents harm to, preserves, or enhances individuals' interpersonal relationships, psychological wellbeing, opportunities for personal growth, mental health, or satisfaction with the process and outcome of the matter.*  
(Daicoff 2009)

### 1.1.2 Basic Concepts of Proactive Law

The idea of proactive law undeniably builds on the preventive law movement, and authors in proactive law constantly refer to preventive law as the origin of proactive law. Proactive law encompasses the basic principles of preventive law described above, namely preventing what is not desirable, keeping problems and risks from materialising. Therefore this handbook chapter covers

both: proactive and preventive law.<sup>62</sup> To the *preventive* dimension, proactive law adds a second aspect which is often neglected in traditional law – the *promotive* (or positive, constructive) dimension (promoting what is desirable; encouraging good behaviour). While preventive law prevents ill-health, and problem prevention, proactive law promotes *legal well-being* and clients *self-care* (Haapio 2006). Louis M. Brown's work on preventive law was targeted toward lawyers. While influenced by his work, the proactive law approach emphasizes the importance of collaboration between legal professionals and other disciplines. In the words of Soile Pohjonen,

*[Preventive Law] favours the lawyer's viewpoint, i.e., the prevention of legal risks and problems. In Proactive Law, the emphasis is on achieving the desired goal in particular circumstances where legal expertise works in collaboration with the other types of expertise involved. In Proactive Law, the need for dialogue between different understandings is emphasized.* (Pohjonen 2009, 470, 477)

Again, proactive law is not new in itself (Magnusson Sjöberg 2006); there have always been proactive lawyers and other legal professionals acting in a proactive way, or proactive elements in contracts or legislation. The objective of the proactive law movement is to identify and generalize this shift in legal thinking, collect and evaluate practical experiences, develop theoretical studies and concepts which show what can be gained in developing forward the proactive dimension of the legal domain and interdisciplinary collaboration between lawyers and managers or subject-matter experts from for example technical fields. Cecilia Magnusson Sjöberg clarifies that the notion of law in this context “is not equivalent to rules and regulations, but refers instead to law as an instrument that can be shaped in a whole variety of ways, e.g. a basis for risk analyses, legal system design and management.”

While preventive law originated in the US, in response to the adversary Common law system, proactive law has evolved in the European, less litigation oriented, Civil law context, which explains the different focus. Also, the context in which proactive law has developed and continues to develop is very different from the preventive law movement in the US. While research on preventive law and the comprehensive law movement in general is predominantly located in US law schools, concerned with traditional legal topics such as litigation, criminal law, corporate law, employment law etc., the

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62 It also covers “creative problem solving”. It can be argued if this is a specific vector of the comprehensive law movement, see Daicoff 2005, 22–25. As part of preventive law, see Barton & Cooper 2000.

proactive law movement from its early stages has been truly interdisciplinary and business oriented. It pays particular attention to non-legal disciplines such as project management, quality management, contract and risk management, legal document management, ICT. Referring to Table 1, presented above, preventive law so far has focused on the secondary and tertiary level of legal care, while proactive law concentrates on the primary causes of legal disputes.

**TABLE 1.** *The main differences between preventive law and proactive law can be identified as follows (adapted from Haapio 2006, 25).*

Preventive law focuses on	Proactive law focuses on
Managing conflict and handling problems	Eliminating causes of problems
Avoid litigation	Achieving desired outcomes
Managing risks	Balancing risk and reward
Minimizing costs and losses	Creating value
Professional legal care	Shared care and team approach, lawyers supporting client's self-care

Recently more mutual influence between European and US researchers can be observed. On the one hand, the proactive and interdisciplinary dimension has been added to the preventive dimension of preventive law (see principle 4 above), on the other hand common interests have been discovered between the European proactive law movement and the emergent discipline of law and strategy in the US (Siedel & Haapio 2010).

## 1.2 CONCLUSIONS

Though proactive law has only developed recently, and literature, compared to other vectors of the comprehensive law movement, is less abundant, at this stage the following principles of proactive law can be identified:

- 1) Legal certainty, literacy, and multidisciplinary analysis: In the words of Helena Haapio proactive law is about “localizing the mines and preventing them from exploding” (Haapio, 2006, 21). Today’s legal system evolves rapidly. Requirements for corporate compliance, environmental and safety standards,

regulation of the information society etc. are constantly growing. Therefore not only legal experts need to be informed about the law, but management and employees need to be aware of the legal “mines”, as well as lawyers need to be knowledgeable about the business processes and objectives of the company they are counselling. Recent scandals such as Enron or WorldCom have shown how integrated law and business life are. It is not only about compliance with the law, but ethical standards and the reputation of a company are at stake as well. Therefore, in addition to avoiding lawsuits through compliance with regulations, companies need to engage in multidisciplinary analysis. They need to manage their compliance with the law and align it to business objectives. In order to be able to do this, not only lawyers and regulators need to know the law, managers and other actors in society need to have at least a basic understanding of the legal “mines”. They need a basic legal literacy awareness, or legal astuteness (Bagley 2008, 378, 383), which in the end can help them not only to avoid litigation and the costs related to it, but enable them to use the law for competitive advantage. (See generally Siedel & Haapio 2010, 641, 667–668; Dimatteo 2010, 727, 728)

- 2) Creating economic value (prevention/outcome orientation): Preventing legal disputes may save costs and time wasted by legal proceedings, but from an economic standpoint this is not enough. In order to convince companies of the importance of the law, lawyers need to be able to show to their clients not only the negative side of law, constraints that are “in the way of business”, but also the economic value, the opportunities creative use of the law can offer to build solid business foundations, roadmaps for performance, trust, better, sustainable business relationships.
- 3) Dispute pre-emption: In proactive law the focus is on dispute pre-emption, legal risk management, rather than dispute resolution (Susskind 1998, 292). Though there is need for case studies to prove the following, if proactive law is practised correctly, there should be no need for dispute resolution at all. Many legal disputes are due to misunderstandings and disappointed expectations. The objective of proactive law is to avoid getting to the stage of dispute resolution, through careful attention to legal clarity, early warning mechanism and enhanced collaboration between business partners, with mutual goal orientation.

- 4) Early cross-professional collaboration and understanding: For proactive law cross-professional collaboration between lawyers, managers and subject matter experts, such as the engineers in charge of the execution of the goals set for in a business contract, are essential to reach common goals and to avoid problems and legal disputes. A common understanding is necessary, and it can be enhanced by the use of non-traditional legal communication tools such as visualization. (See generally Berger-Walliser, Bird & Haapio 2011).<sup>63</sup>
- 5) Creative thinking: Because of the outcome orientation of proactive law, and as proactive law looks towards to the future rather than past experiences, it requires the ability to develop new ideas and concepts from all actors in order to respond to needs, problems or challenges, by means of an original and previously non-existing result.

The principles above have led to the following description of the proactive law approach:

*... a future oriented approach to law placing an emphasis on legal knowledge to be applied before things go wrong. It comprises a way of legal thinking combines with a set of skill, practices and procedures that help organizations and individuals to identify opportunities in time to take advantage of them-and to spot potential problems while preventive action is still possible. In addition to avoiding disputes, litigation and other hazards, proactive law seeks ways to use the law to create value, strengthen relationships and manage risk.*<sup>64</sup>

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63 See also: [www.legalvisuals.com](http://www.legalvisuals.com).

64 Nordic School of Proactive Law, Welcome to the website of the Nordic School of Proactive Law, <http://www.proactivelaw.org/>. This site is maintained under the leadership of one of the pioneers of Proactive Law, Professor Cecilia Magnusson Sjöberg, Director of the Swedish Law & Informatics Research Institute at the University of Stockholm.



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## 2 A PROACTIVE APPROACH TO LAW FOR LAWYERS

*Eric van de Luytgaarden*<sup>65</sup>

### 2.1 INTRODUCTION TO THE PROACTIVE LEGAL PRACTICE

The world is changing. In this chapter this statement will be enlightened with reference to the legal profession. For, not only the world changes, but in pace with it business changes, politics change, and human relationships change all the time, and lawyers<sup>66</sup> should change too.

The paradigm underlying lawyers' performance and the general attitude of the legal professionals is reactive. They tend to await the (legal) problem to increase to the fullest before they step in. Power, separation and rules are the three assumptions under which a lawyer provides his services. Proactive law seeks to change the paradigm, in order to prevent legal problems and promote desired outcomes of lawyers' work in the process of doing business. The proactive paradigm will then be understanding, integration and accommodation, according to Barton who now holds the chair of preventive law at the California Western School of Law.

This paradigm change does not come as a lightning from a clear sky. Society changes, people change, and it is our preliminary hypothesis that lawyers have to change too. Therefore the introduction to this chapter draws a very broad sketch of tendencies of a changing society.

### 2.2 WHY LAWYERS NEED TO CHANGE

In the Western world, predominantly in Western Europe and more specifically in Scandinavia and in the Netherlands, sociological analysis of the past 50 years reveals certain developments. Tendencies in society that are crucial to the

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65 This is a rewritten part of his book 'Andere Juristen', to be published in 2012.

66 I will use the words legal professionals and lawyers as synonyms, meaning a person with a law degree who works in the field of legal services.

way individuals live and work, tendencies that are crucial to the way we design professional education. Society has changed, generally speaking, from vertical authority based nationalistic to horizontal, individualistic and globalised. This change has obvious consequences for inter-human relationships, it has consequences for the way we shape rules and regulations and it has to have consequences for lawyers and the shaping of their professional attitude. The legal paradigm could be submitted to change, for all kinds of law and lawyers, from public servants to business lawyers. This new legal paradigm requires a more proactive approach. It seeks to prevent legal conflicts from occurring and to tackle them before they really blossom. Hence, it is a future-oriented approach the goal of which is to promote what is desirable and to *ex ante* maximize opportunities while minimizing problems and risks. The sociological analysis and the consequences for law and lawyers will be explained from a bird's eye view in the next chapter.

### 2.2.1 Miscellaneous starting points

Society has changed with all due consequences for individuals – and lawyers.

In 1999, the American legal historian Lawrence M. Friedman published *The horizontal society, a vision of Western societies* (Friedman 1999, cf. Hofstede 2010). The world we live in, as far as the western view is concerned, is a horizontal world, not vertical, not hierarchical, but flat and full of opportunities, so he claims. Our society is no longer characterized by the fact that someone's birth automatically predestines what this person's place in society will be. The old entrenched social location of individuals has the possibility to shift. Society is characterized by opportunities and questions, such as: what does someone do with his abilities, competences and life achievements and to which different groups or social networks does one belong, are the discriminating factors in contrast with the old postulates such as: where were you born, who are your parents, to which social class do you belong.

Individuals have numerous opportunities and have to rely on their own resources and accomplishments. Belonging to a particular group, class or social origin is nowadays less important for the development of an individual than a hundred years ago. People from diverse backgrounds can become anything or anyone and are now more than ever responsible for their own lives.

The old world up until the mid-nineteenth century was strongly influenced by family traditions, religious background and origin. Nowadays, the world is a place where people can make horizontal ties with like-minded others. People are determined by what they do or have done instead of where they come from and the responsibility for one's own development to become who one really is has never been more important than today. This is called the meritocracy (Bovens & Wille 2011, 73) or diploma-democracy.

Friedman's horizontal-society-thesis requires an analysis of society as a society of people in which individualization and mobility are central: a world, where the leading idea is increasingly focused on individuals, and their competence to adjust and change. This will, as we shall see later in this chapter, have consequences on the impact of law and lawyers in society. Friedman's horizontal society is also characterized by the Dutch sociologist Boutellier (2007) as the nodal order. Nodal is derived from the Latin node which means junction, knot, nodal point, in other words a horizontal network society. Social networks, mobility – both literally and figuratively – and using the Internet, and the famous proposition that every individual is connected to another acquaintance, only six steps or persons away. This all means that interconnection, knotting networking is a reality now more than ever. Imagine all the legal framework that underlie all these networks, all the contracts, all the laws and regulations that allow us to travel, surf the world wide web, use Facebook, Twitter and so on. It has been a huge effort not only of the IT professionals but also of lawyers to make the horizontal, nodal society possible. The slowly and silently growing influence of technology going hand in hand with the law and lawyers is enormous.

### 2.2.2 Citizenship

Our Western society, the civil society, is based on a concept of citizenship (Friedman 1977, 92–96).<sup>67</sup> The traditional concept of citizenship in civil society plays an important role and given the changes, for instance, the increasing individualization and social mobility, citizenship has to be renewed. Society requires a new form of legal protection of individuals or at least a change of the fundamental character of this protection. This will be what we later on call the impulse to the proactive paradigm change in law. There is

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67 Compare Ehrlich 2002, 147, 203, 388 and Unger 1976, 37–40 and Alting von Geusau, 2009, 29–34.

more to proactiveness in lawyering and business which are explained in other parts of this book.

The most important factor of citizenship from a legal viewpoint is the protection of the traditional three-fold division of fundamental rights: classic civil rights and liberties, political participation rights and socio-economic rights. This division still holds the main legal framework of Western democracies, I realize there is more to the civil society than the protection of these rights, but this will not be discussed here, as they are discussed in a number of publications written on this subject.<sup>68</sup> For now, the focus is on the protection of rights.

The German sociologist Max Weber has already pointed out that in a modern society civil protection alone through the concept of protection of fundamental rights is no longer enough – society has to be viable. Viability is essential to a globalised world since globalisation means, generally speaking, that society is involved in a process of rationalization where habitats are increasingly being controlled: control in bureaucratic and scientific terms, in legal or even quantitative terms. Protecting individuals in their horizontal mobility by means of the concept civil society and the sole protection of their rights is therefore no longer adequate. In other words, the legal protection of rights alone is an insufficient means to guarantee citizens' individual development. It is essential, but not enough. There has to be some sort of what in literature is called predictability, in order to make society viable. Predictability is, among other things, passing of surprises, manageability and accountability seen as the central notions of everyday life. Seen from the legal perspective it is a development from reaction via prevention to being proactive. It is not the desired idea of a society, but its management that is the *Leitmotif* of politics. This contribution will outline developments which explain that in a horizontal society, or a viable society, different concepts of dealing with lawyers and the law is required: a predictable concept, or a preventive concept or even better, a *proactive concept*.

Until recently, the paradigm of law and lawyers was predominantly reactive. In traditional legal thinking, lawyers were trained to respond in an adversarial way to problems involving conflict or opposition. Formal legal rules are their reference as well as their instruments. Admittedly, in some areas the formal law has been extended with soft law instruments, but even there the problem solving approach of the lawyers is the traditional one. Prediction, prevention or even

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68 See for more on this: Etzioni 1993, 1997 and 2001; Putnam 2002; Friedman 1985; Sennett 2008 and Ehrlich 2002.

being proactive is simply not at the core of current lawyering. As a consequence, the use of legal skills is mostly secondary to actually solving problems. Whenever things go wrong one turns to a lawyer, and in the event of a major predicament one has the courts to unravel the knots. If it were only the legal knots there should not be any problems since lawyers are trained to unravel them. However, most of the problems in society are not legal *per se*. They just have a legal component. Therefore, it is a necessity to change the paradigm, which is at the basis of legal thinking. The traditional paradigm of legal training evolves around rules and procedures, conflicts and opposition, whereas the new paradigm reflects on understanding, integration and accommodation. This new legal paradigm requires a more proactive approach. It seeks to prevent legal conflicts from occurring and tackle them before they really blossom. Hence, it is a future-oriented approach the goal of which is to promote what is desirable and to *ex ante* maximize opportunities while minimizing problems and risks.

## 2.3 DEVELOPMENTS IN WESTERN SOCIETY

Trends in Western society – as observed by many scholars – can be characterized in general terms, such as globalization, horizontalization, individualization, devaluation, de-authorization, McDonaldization (Roberston 1995, 25–44). Globalisation and our society are more and more characterized as a society of networking and improvisation (Boutellier 2007 and 2011. cf. Castells 2000). What is meant is that societies are becoming more and more alike throughout the world. Due to the Internet revolution and the growing richness of people, both in terms of wealth and knowledge and in terms of literacy, there seem to be no boundaries at all as to what is possible (globalisation). The world has predominantly become flat. We are able to real life chat with others on the other side of the world; we can drink coffee and eat at similar restaurants anywhere in the world (e.g. Starbucks and McDonalds). This, however, means that people have to rely more and more on their own moral values and individualism; authorities, such as the ancient kings and queens, but also the pastor, the teacher and the *pater familias* are no longer sacred and present and are certainly not taken for granted. People tend to create their own authority and pick examples to mirror themselves from sportsmen to movie stars and all other sorts of celebrities, which they can see and follow in the comfort of their own houses, by means of the internet and media like television and social networks such as Facebook and Twitter.

At the same time, the local community and feelings of nationalism (Robertson 1992 and Etzioni 1997) and religious fundamentalism seem to grow. This counter-tendency can be explained by the need of human beings having to recognize the local community in which they live and feel comfortable. Furthermore the threats of world-wide disasters such as the environmental pollution threats (e.g. Japan's nuclear plant crisis of 2011), international terrorism (e.g. the recent problems in Libya and the international coalition forces) and the financial crisis (e.g. the current financial crisis in the EU concerning Greece, Portugal, and Ireland) make people turn to their local communities in quest of social safety. These tendencies seem to be the result of a worldwide interconnected system of almost anything, the horizontal network society. This horizontal network society made out of nodal knots explains the necessity of improvisation. Traditional values and rules are no longer sacred, we have to improvise. For society this seems quite a vulnerable foundation, but as a sociological comfort one could state that improvisation at the same time makes our lives more exciting because of the free character of improvisation, like the influence improvisation has in Jazz music. Every musician could blossom in his/her own right; this could also be the benefit of a society based on improvisation, each and every individual could become whoever he wants to become and develop into anything one desires.

Society consists therefore principally of individuals who, through their extensive choice and mobility, protected by their basic rights as inviolable conditions, can within the boundaries of the law do almost anything that suits them. We live in a horizontal society, a society in which we ourselves decide what and how we want to achieve things: a society of choice, a society of improvisation (Friedman 1990). The modern individuals under the influence of globalisation (Judt 2010; cf. Bovens and Wille 2011, 110), mobility, the lack of authority and the constant urge of empowerment make their own choices in life. Nobody needs to tell them what they can or should do as almost everything is possible, both nationally and internationally.

### 2.3.1 Risk Society

Although this seems one of the major acquisitions of western (legal) development, at the same time there is a great tension in society in cases of protecting rights and the application of legal rules through the influence of law and lawyers. Law is no longer a quiet beacon. But law is primarily seen as an



instrument, which people can use as modern citizens seeking the challenges, or developments that fit in their lives. Law is becoming an effective means to achieve personal goals. For example conflicts that used to be solved in the realm of the family, local community or organization are now out in the open and subject to law and lawyers. This use or perhaps abuse of law and lawyers requires a lot from law, much from the modern citizen and even more from the lawyers. This development carries the danger of legalization and juridification of society, of overregulation and more legal bureaucracy to get everything done to legal perfection. (Ippel 2002; Vago 2000; Susskind 1996). We are talking about the influence of all the law, not only regulations or law made by the national legislator. This development requires a lot of legal professionals, who are trained to solve legal problems but really nothing more. These dangers are real risks to the survival of a stable and viable or even a predictable society.

It was the German sociologist Ulrich Beck (2008) who described this phenomenon as living in a World Risk Society. The increasing pressure from unsuspected angles has as a consequence that citizens living in a society in which they are more assertive, individualistic, and therefore they seem to be more independent are paradoxically more dependent on each other and on law. Inter-humanly speaking there are no real problems, but if the dependence on bureaucratic systems of control or legal rules or even the application of the law through lawyers grow fast, there is a real imminent danger to individual development because of the one-sidedness and primarily legal focus of law and the legal professionals (Beck 2008). The consequence of all this to individuals is that each and every one lives in a sort of a personal legal, sociological and psychological *bricolage* which differs from one person to another (Boutellier 2011, 24–25). People craft their own social cohesion together with values and norms, roles and positions which are continuously reinvented and the only thing that seems to be sacred in modern times is pragmatism. If something works or looks good is has our preference; quick satisfaction and almost living in sound-bites. Of course this seems to be a great concept in business: if something works it should be good, but the actual problem is that law is not about instant satisfaction. Law reflects upon the commonly shared values and norms. The viewpoint of the Dutch sociologist Boutellier (ibid.) in this field states that we tend to live in a pragmacracy. This view seems to be the modern conception of the 21st century citizenship. Equal opportunities and being your own authority, the ideals of the sixties, have been achieved. The contrasts between people who previously seemed insurmountable and led to a vertical society have disappeared. But what do we get in return and how do we

have to deal with these developments in term of application of legal rules and professional occupation of lawyers?

### 2.3.2 Authority

One of the very important reasons for the above-mentioned developments, which we did not yet discuss, is the decline of authority, which has great impact on lawyers and lawyering as well. Since generally speaking in the 'old days', the father, the vicar, the employer, or indeed the Queen would have decided what had to be done in a certain case. Nowadays these authorities are no longer sacred. If an individual does not want to conform to the opinion of his or her employer, they just leave, or go to court to let a lawyer (a judge) decide. The court system can handle these problems, but is not really made for these kinds of decisions. The number of civil conflicts rises exponentially, the pressure of the upcoming workload is too heavy, but even more importantly lawyers are not trained to take the place of these authorities because of the diversity of decision-making through these authorities. Lawyers are trained to unravel legal problems, and the authorities mentioned are used to taking decisions based on argumentation from different angles. Most of the problems that end on a lawyer's desk nowadays concern issues that are not legal. They are more day-to-day problems or political problems or religious problems. These problems used to be solved in the realm of the family, parliament or church. Some of these matters have of course a fundamental rights side to them and therefore people address the judge and ask him or her to decide, for example, whether one has the right to go out late, to wear a niqab in a classroom, or to say anything one wants before a camera<sup>69</sup>. But, there used to be an authority within the domain of the problem who decided, and not a lawyer. The current social order or cohabitation suffers from the loss of traditional community ties with scientific rationality and the lack of immanent normative structure has become the guiding principle. With secularization and increasing individualization, churches, families, employers, managers, teachers and many others have lost their authority. The only two phenomena that are apparently

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<sup>69</sup> I refer to three cases currently pending before a court of law in the Netherlands. First case is a youngster of 15 years who went to court because his parents want him to be home at 1 am on Saturday mornings, and he wants to hang out with his friends until later. The second case is a 15-year-old Islamic student in a Roman-Catholic high School in the Netherlands who wants to wear a niqab at school while school forbids this. And the third is the case before a court whether the MP Geert Wilders has the right to use the freedom of speech even when he is outside of Parliament and refers to Muslims as a primitive religion which is supposed to be dangerous for Western Society.

accepted as a new authority are the dominance of scientific rationality, i.e. the almost religious trust in statistics of the post-modern times, and the fact that the judge has the so-called last words, in general terms, the trust in law and lawyers. This trust is a choice of poverty; it is so because we do not have alternatives and our society has become over-focused on law. It is not my question whether we should stop the developments that make the appeal on lawyers grow, but to change the professional attitude of lawyers and the role of legal rules towards another direction, because our times beg for change. This could well be the proactive attitude where lawyers try to ex ante maximize the ideal solution in a given case.

It seems that traditional values such as compassion, empathy, respect, work ethics, listening, letting time take its course are of lesser importance. In a conflict situation, for example, between an employee and an employer, government and citizen, a parent and a child, there no longer seems to be a social value system that offers a profound and sound solution. It seems more and more that these situations are directed to a value vacuum. It is not to say that there are no values, but most of them are not shared values, or at least their importance is discussed. Therefore, in cases like the above mentioned (and one can easily think of hundreds more) people often turn to law and lawyers in modern Western societies. The court is objective, relatively quick and there is no question as to its authority, it is conferred by law. There is more evidence of this phenomenon, for instance, the increase in legal protection against the government in administrative law in the nineties of the past century; the ever increasing appeal to the courts not only in cases of family disputes, such as supervision orders, inheritance and the growing number of divorces, but also in religious matters in a multicultural society and in matters concerning the freedom of speech and expression.

### *Lawyers as professional surrogates?*

Our society is also referred to as the society that lost its community character and the law, and therefore its servant. The lawyer took over the role of the binding force in inter-human communities. There are convincing signs of law, at this stage in the development of society, being a welcome temporary alternative as it is democratically founded, but ultimately the law was and is not created to be a (value) authority. In other words, people must learn to settle their conflicts themselves primarily and generally by speaking and not by

addressing every trifle to a lawyer to claim what seems to be one's own. Friedman (1990, 12) puts it more strongly: he argues that the decline in authority and substitution by law and lawyers is even dangerous. A culture cannot survive without some kind of a human authority. Legitimacy of authority is necessary for the functioning of a legal system. The law itself is just a group of rules that ensures that the game is played well, preconditions for the functioning of a society founded on certain values. Boutellier (2005, 31) agrees with Friedman, but has a more positive view: according to him, we experienced a democratization wave in the second half of the 20th century. With the so-called Kantian imperatives at hand there was a secular revolution, meaning that each and every individual was his own "god" and could choose his or her values. Society has not become easier, but far more diverse and exciting. This is what he means by improvisation society, a society which hassles without commonly shared ideas and with an *ad hoc* policy and a seeking government, but he sees improvisation also as organized freedom, a continuous agitated movement that therefore (perhaps involuntarily) organizes consistency and coherence in the variety of choices, values and the like. (Boutellier 2011, 7)

While the ancient authorities decrease, law, lawyers and their influence will increase. It is a choice of poverty, Friedman said, but it is an everyday development. The danger is that we leave society largely in the hands of lawyers without noticing it. There is another disadvantage: lawyers have, what Friedman calls, a parasitic profession, as they produce nothing. This has a great impact on society when a growing group of professionals live on the problems or lack of resolution power of others. Or even stronger words: the misery the citizens find themselves in indicates the legal profession as an important rationale. More and more parts of the society are saturated with rules, because we have lost the ability to solve problems by ourselves and lack the ability to make decisions by ourselves, internal leadership of each and every individual is diminishing and lawyers are the professional substitutions. The same applies for business law, where managers could lack the ability to take decisions and make distinctions, and then turn to their lawyers to make decisions for them. It is this development that preventive or proactive law and lawyering want to face.

### *Three trends*

Given the fact that the influence of law is growing, this trend has gradually become so dominant that we develop into clients of a specific lawyer society rather than citizens of a democratic or civil society. So there are less and less organized parts of our world or our culture where law does not affect us; in other words, society is becoming less immune to the law. This development is perfectly described as the rise of legalism – more and more rules govern more and more parts of our society. We can distinguish three main forms:

1. The liability explosion, organizations (companies and governments profit and non-profit organizations) may have no immunity. There is a wave of liability going through the society. People, organizations and governments are held responsible by the law of almost all their actions, there is no premature, preventive resolution system, almost no solidarity between the humans and everyone is held accountable for his or her deeds. The reverse of the medal of individualism is total responsibility.
2. The almost sanctity of the adversarial principle. Organizations, especially the government cannot legitimate acts, unless the other person, usually the citizen has the opportunity (enshrined in law) to object and fight back.
3. There are no more areas in society where the law has nothing to say. We have come so far that in all forms of our lives, even in the most intimate interpersonal part, the rights rule. It is obvious that this is only invoked when things go wrong but also in prescribing behaviour, all claims made as to how far physical intervention is authorized by parents in raising children, something that used to be closed secrets belonged to a family. The German sociologist Jürgen Habermas speaks in this context of the colonization of personal life by the law. (Friedman 2005, 15; Habermas 1976, 356–373).

The decreasing respect of authority is inextricably linked with the growth of rules and the law in all its forms as an artificial replacement of that authority. What used to be governed by just a word or a social norm or was enforced by behavioral factors must now be enforced through a legal process. The inherent disadvantage of a legal procedure is that it is technical, reactive, mono-disciplinary, focused on separation, rules and power. So the key is that human emotions and human values are regulated by technical, analytical and legal systems, reasoning as well as rules and judgments instead of by necessary coexistence, human emotions, creative thinking, multidisciplinary

analysis, cross-professional competences and integration, accommodation and understanding (Barton, 2009, 27; cf. Siedel and Haapio, 2011, 109).

### *What does this mean to the legal paradigm?*

The “blessings” of the 21<sup>st</sup> century are partly made possible through the work of the legal professionals – their influence is huge and still growing. In that sense legal professionals are in control. However their training, the paradigm underlying the study of law, is not made for that position. They are, as is explained in other parts of this book, trained to apply, explain or even use the law in terms of regulations, contracts and conflicts.<sup>70</sup> Lawyers are therefore important and have a huge impact on our lives, but are not really trained to foresee problems, to broaden their horizon, to think creatively and out-of-the-box, which are all necessary components to fulfill their jobs of an increasing importance. They are trained to think within the narrow margins of the law, to act reactively and not proactively, to find the best legal solution which is not necessarily the best inter-human or business-like solution. It is therefore important that society now has become increasingly more horizontal and nodal where the essential human values are monitored and preserved. What could the function of law be then? And more specifically what lawyers could contribute to the monitoring values just mentioned?

Lawyers could shift their thinking and their work from responding to acts, conflicts and deeds to prevention of conflicts and being proactive with regard to values and building values in society. In that order being a lawyer would be a more sustainable profession. Preventive and proactive lawyers should instead of analyzing the legal disease under the microscope to observe and try “to cut it away”, look at the overall context, the clinical picture, from which a legal disease has arisen, and to prevent them to start growing in the first place. Lawyers can do more than they now do. Their professional focus should be on prevention and being proactive for the general part of their work, and reactive for the specific legal part of their work. Proactive law is therefore a legal method representing a future oriented approach to law, based on the view that legal knowledge is at its best when applied before things go wrong. Literally: being proactive is the opposite of being reactive or passive. The word

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70 I am not referring to criminal law here because of the monopoly for the government to punish and the specific character of penal law. Besides that penal law only covers approximately 5% of all the work lawyers are involved with; despite the attention it gets through media, this is a rather small number.

proactive implies acting in anticipation, taking control, and self-initiation. These elements are all part of the proactive approach to law (referring to Proactive Law), which includes two further aspects of proactivity: a promotive dimension (promoting what is desirable, encouraging good behaviour) and a preventive dimension (preventing what is not desirable, keeping legal risks from materializing)<sup>71</sup>.

If lawyers would be willing to change, then the conceptual thinking concerning law has to change. Their training should produce a paradigm shift, offering a method focused on success, one directed on prevention rather than cure. The classical paradigm would therefore need to be replaced by a renewed paradigm; the proposals on preventive and proactive law explained in this book are a good guideline in that direction. Society has changed – we are waiting for the lawyers to change too.

## 2.4 CLOSING REMARKS

Firstly, the classical paradigm in the traditional legal training focuses on conflict, legal analysis of a case and the (re)distribution of power between parties. Due to a changed society this paradigm is an anachronism and has to be replaced. Secondly, not only the number of lawyers working in society, but also the number of law and regulations has grown. Classically trained lawyers are not up to the challenge of a changing, horizontal society where prevention and acting proactively is more and more important; therefore their professional values have to change. Thirdly, society claims that the individual has to make more choices than ever. In a society of choices with the risk of things going wrong, where the individual has to fight more often for his or her position, people fight faster and easier than before, and end up more frequently in a court room. The proactive approach reveals the idea that lawyers should try harder to prevent people from ending up in lawsuits.

Fourthly, the horizontalization and globalization of society, which underlie the legal empowerment of the citizen as a consequence, the accessibility of the law as the influence of media and the Internet, and the decline of authority in general, provides a flatter world, where more often an appeal is made on the law or lawyers, because people do not get what they want; whether that is just

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71 See for more Magnusson Sjöberg (2006, 13) and Siedel and Haapio (2011, 11).

or not is left in the middle. The flattened world makes sure that the number of legal questions grows and the nature of legal issues changes from typical legal questions to broader questions, where multidisciplinary and creative skills are necessary for lawyers to tackle these questions. Lawyers have to be aware of that fact and have to ‘reset’ themselves in these terms. Fifthly, there is a certain degree of over-regulation. The European regulatory influence on our daily lives is an example, but the increasing regulation by the socialization of law is more important. This occurs when law is used as a tool for societal changes such as stricter environmental and immigration law. It was not discussed here, but it surely changes the role of lawyering, one could image.

Sixthly, and as a general conclusion, instead of focusing on the technical details of law and lawyering one should focus on how lawyers could help in preventing legal problems and promote what is desirable, in other words: be proactive. This could be done in a way which predominantly sees opportunities instead of threads, which encourages good behaviour from the viewpoint of the client and which permanently minimizes legal risks from materializing. How this could be reality will be explained in the chapters to follow.

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## 2.5 PROACTIVE LAWYERING

*Jos Janssen*

In the introduction to this section, it was stated that the goal of proactive law for legal professionals is specifically to become “multi-dimensional” in order to serve their clients better (Barton 2000). This requires legal professionals to obtain knowledge and skills to think proactively and to develop capacities to provide proactive legal services. Thus, their services will have to be based on the key proactive competences: multidisciplinary analysis, cross-professional communication and networking, creative thinking, and outcome orientation.

Probably the biggest challenge to lawyers is to make an interdisciplinary analysis of their work, as their training usually is mono-disciplinary, i.e. in law only. Therefore, in order to be able to provide proactive legal advice to their clients, business lawyers need basic knowledge of business management theory. To that end, some basic concepts of business management are presented in the chapters above and in the chapter below. This should enable business lawyers to understand their clients better. In fact, for obtaining a business mind-set it is indispensable for business lawyers to work cross-professionally and truly understand the clients’ needs in doing their business. In that sense, the lawyers’ traditional frame of reference, the legal system, needs to be broadened in a way that includes a basic understanding of business management as well.

Then, as the next step, it has to be determined what a proactive lawyer will in fact offer his or her client as a service? In other words, how can business lawyers effectively combine their legal knowledge with the understanding of business processes in order to add value as a proactive lawyer? In this part of the chapter we will present a practical model to be used by business lawyers that will enable them to provide proactive legal services. Eventually, to apply this model in practice will contribute to the goal of using law as “a source for sustainable competitive advantage” (Bird 2009; Siedel & Haapio 2010 and Siedel & Haapio 2011). Thus, in providing their services, proactive lawyers use the law to create value to the business in general.

### 2.5.1 From preventive to promotive legal services

Proactive law has two dimensions, both of which underline an *ex ante*, the future oriented approach: 1) preventive dimension and 2) promotive dimension. The preventive dimension favours the lawyer's viewpoint (preventing legal risks and problems) whereas the promotive dimension represents the business viewpoint (promotion of business goals). A proactive lawyer incorporates both a preventive and promotive focus and will aim at achieving both legal and business goals. Consequently, the proactive law approach implies collaboration and dialogue between the legal expertise and other disciplines such as business management. For a lawyer to move from a traditional preventive approach to a promotive approach, it is necessary to move from a professional focus on "legal risks and problems" to "business opportunities and solutions". From a practical point of view, the instruments of a legal audit and legal risk assessment can be used to identify legal risks and problems. Next, one has to see if and how these can be transformed into business opportunities. However, first the lawyer's approach to business law needs to be adapted to fit with the business professional's viewpoint. This can be achieved through the "managerial law approach" to be discussed next.

### 2.5.2 The managerial law approach

Having obtained basic knowledge of business management as a lawyer, the question remains: how can this knowledge effectively contribute to the provision of legal services or businesses? For example, what is the added value of a SWOT analysis of the business processes of a certain company for the lawyer advising that company? The concept of "managerial law" as introduced by Antoni Brack (1997, 237–244) could be a useful tool for proactive lawyers. Brack introduced the notion of "managerial law" for the purpose of teaching law at business schools. In essence, it is about linking legal topics with business functions. According to Brack (*ibid.*), business law is inherently interdisciplinary and should therefore be integrated with the interdisciplinary fields of management. This means that business lawyers have to sacrifice traditional legal structure (domains of law) for the structure of business functions. That is, for business professionals the traditional legal structures have little practical and operational meaning. As a consequence, a business lawyer should look at companies in the way business professionals do. The managerial law approach is in fact a functional law approach. From a business professional's point of view the following five functions can be distinguished (Figure 2).



**FIGURE 2.** *Five management functions.*

If the business lawyer has knowledge of business practice and a business lawyer’s imagination and experience, legal topics can be placed in the structure of the relevant business function. The structure presented here can be used as a starting point in designing a format for a business legal audit (Brack 2001, 34–39). Obviously, the business functions and relevant legal topics presented here may vary according to the nature of the business concerned. The example used is largely based on a production company. It may be noted that the model presented here may serve as a basic starting document that has to be developed further into concrete checklists containing all relevant legal topics for the company concerned.<sup>72</sup> In fact, the conduct of a business legal audit is a very practical assignment, which is inevitably tailor-made in order to serve the specific company’s needs. It also requires a broad knowledge of business law in order to identify all relevant legal issues.

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72 Cf. Due diligence checklists.

Management function	Business topics	Legal topics
Human resource management	Staffing, terms of employment, working conditions, labour relations	Labour law, social (security) law
Production/operations management	Pre-production, production process, after-sales	Product liability, product safety, environmental law, consumer law
Commercial management and marketing	Product, place, promotion, price	IP law, commercial law, advertising rules, consumer law, contract law
Financial management	Treasury, control	Financial law, company law, securities law
Strategy management	Corporate legal identity, competitive environment	Company law, competition law

**FIGURE 3.** *Format for a business legal audit, based on Brack 2001.*

### 2.5.3 The legal audit as a starting point for proactive lawyering

At first sight, a legal audit can be considered as a rather traditional tool for lawyers to be used for the purpose of legal risk management. However, the legal audit has the potential of becoming a tool for providing proactive legal services.

In a traditional sense, a business legal audit is a diagnostic assessment of the legal situation of an enterprise<sup>73</sup>. It might have a neutral, descriptive purpose in the sense of taking a legal X-ray of the company at certain moment in time. The result will be an assessment of the legal performance of the organization which can be used to formulate recommendations on how to improve legal performance. According to Brack, these recommendations could have a defensive and an offensive objective. In fact, this could well be matched to the preventive and promotive dimension of proactive law. Whereas the preventive function of the legal audit is merely aimed at managing legal risk, the promotive function of a legal audit should be to discover new opportunities for the business organization. In doing so, law becomes an instrument to create value. If business lawyers want to play this role, they will have to acknowledge the importance of opportunity recognition and innovation, and therefore broaden their horizon beyond their legal expertise. Instead of focused legal thinking they should try and learn general business thinking. However, this requires

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73 Definition derived from Brack 2001.

that lawyers leave their own “comfort zone”. The ideas and tools presented there can be used by proactive business lawyers who want to find new business opportunities for the company concerned.

### 2.5.4 Towards a proactive legal business scan

In order to provide proactive legal services, business lawyers will have to take the outcome of a legal audit a step further than merely managing the legal risks of the company. In addition to the preventive function of the legal audit, its promotive function should to be exploited. This means that the company’s opportunities from a legal point of view should be actively explored. Using the legal audit as starting point, the proactive lawyer should take three steps resulting in proactive legal advice for a company:



**FIGURE 4.** *Steps for proactive legal advice.*

Next, how the three steps can be executed in practice will be explained.

#### *Identification*

Identification of the relevant legal issues in the company’s business processes can be achieved through application of the managerial law approach. To perform a legal audit on the basis of the model presented above along the lines

of the five management functions will provide insight in the legal performance of the company. A full-scale legal audit can be done on the basis of checklists containing the relevant legal issues that are related to the five management functions. The listed legal topics should represent the relevant issues for assessment of the company's legal performance and the structure of the list should fit the organization chart of the company.

### *Assessment*

Once the relevant legal issues have been established they have to be assessed in terms of a legal SWOT-analysis of the company concerned. Accordingly, legal strengths and weaknesses of the company will be identified as well as the legal opportunities and threats. In as far as weaknesses and threads are identified this information will be used for actively managing the legal risks of the company. Often this will imply the enhancement of business processes. This part can be regarded as the preventive component of proactive law. The promotive component of proactive law seeks that the company's (legal) opportunities are recognized as well. Therefore, the business lawyer has to be trained in opportunity recognition and innovation management, which basically demands the lawyer to move from focused legal thinking to more general business thinking. Several practical tools are available to achieve this. As a result, the assessment will present the legal risks to be managed and, perhaps more importantly, the future opportunities (from a legal point of view) to be further explored and developed by the company.

### *Development*

Since proactive law includes the promotion of desired business goals, it is not enough for a proactive lawyer to identify opportunities for the company from a legal point of view. The proactive lawyer will only create value if the signaled opportunities are indeed developed. Therefore, the business lawyer must contribute to the actual development of the opportunities in cooperation with the business professional. With regard to the established legal weaknesses it also involves the lawyer's contribution to the improvement of business processes. This should be an ongoing process in which both lawyers and business professionals act in a proactive manner with a focus on both legal and business goals. To achieve this, it will be necessary for business professionals and lawyers to communicate effectively. Therefore, the business professional



should have a basic understanding of the law. The role assigned to business professionals in proactive law will be addressed in the next paragraphs.

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## 2.6 LAWYERS UNDERSTANDING THE BUSINESS ENVIRONMENT

*Meine Jansma*

In the sections above, proactiveness is presented as an addition to the traditional way of providing legal services. The proactive aspect of law, including its promotive dimension, has often been neglected in traditional lawyering. While preventive law prevents ill health and problems as well as damage, proactive law promotes legal well-being and clients' self-care. This chapter focuses on understanding the business client and will discuss in more detail how proactive law can be realized in the business environment.

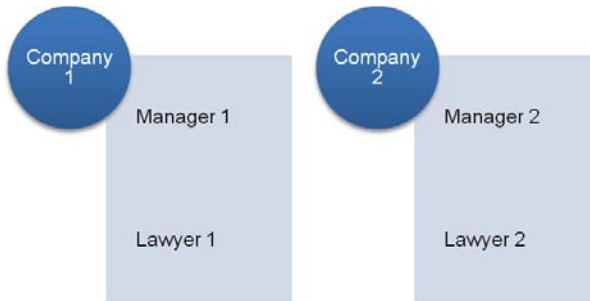
Law itself is an outcome of a law-making process, which in real life is a time-consuming process with long lead-times. However, in practice individual businesses have to deal with the immediate, current situations, their strategies and market developments as well as the political environment. This chapter seeks to enhance proactive law with an understanding of the business environment. The focus will be on lawyering and how it could be applied in a proactive way by using business insights.

Law (or regulation and even self-regulation) sees a desired situation in the future. The smallest piece of self-regulation we could mention is a contract between two or more parties. Thus we can discern different levels in proactive law, regulation and self-regulation. One of the competences developed in the Proactive Management and Proactive Law project is the multidisciplinary approach: connecting disciplines, such as law, engineering and management. However, connecting disciplines is not limited to those mentioned only. One can, for instance, think of a connection between art and law.

In this chapter, the connection between business and legal disciplines will be explored in more detail. The emphasis will be on creating and delivering value to business clients by legal professionals. The central question therefore is the following: Is it possible to get more value out of legal services to the client's business and, at the same time, gain more value to the legal service provider?

## 2.6.1 Exploring the object of discussion

Imagine a dispute between two businesses brought before a court of law. The dispute would most commonly concern a breach of contract. In this imaginary case (Figure 5) at least four parties are involved. Company 1 (C1) has started the process by hiring a lawyer, lawyer 1. Company 2 (C2) received a letter from lawyer 1 and hired lawyer 2. The counsels start a time and perhaps even money consuming communication researching the case and explore the legal aspects of the conflict. Both advise their clients on the strategy concerning how to win the case or on what strategy will be best to defend their positions.



**FIGURE 5.** *Players in an imaginary case.*

One thing is certain: all parties involved want to get the best out of this situation, including both of the companies and the lawyers. Company 1 wants to win, but company 2 wants to win as well. But is winning the case the best option or could there be more to win for all parties involved?

This type of a situation is not only costly, but also lead-time and action time consuming. The energy and attention the companies and managers involved have to spend on the conflict are increasing. And last but not least, the situation is causing uncertainty for both companies. The lawyers, on the other hand, usually earn money for the time spent on hourly rates on both sides. One could think that for them, the maximization of value can only be done by spending more hours and extending the lead-time. (It has to be said this is often the perception that businesses and clients have of lawyers.) But that is not what we want to emphasize. There are other ways in which lawyers can deliver more value to their clients in return of the same or even higher

earnings, even in cases where conflicts have escalated and parties want to file an action. In situations like this, other kinds of competences are needed and required: creativity and out-of-the-box thinking as well as outcome orientation. Outcomes more valuable than winning the case in court can be envisioned.

There are other ways of maximizing the value earned by all the parties involved and minimizing the price paid. This is where the theory of business market management comes in. In management theory, the following basic principles are presented:

1. Suppliers (of legal services in this case) must have an accurate understanding of what the customer firm values or would value. Legal service firms (law firms) or in-house legal departments are the suppliers of legal services to external clients or the same organization. In fact, this should be one of the objectives of every professional who provide legal services.
2. Professionals have to deliver more value than the total cost of their services, including their own profit. This is also becoming more relevant to the legal service markets. In the equation, the total cost must be less than the total value delivered. It is not only money that counts when value is estimated. The definition of Business Market Management used to be predominantly focused on functionality, performance and other tangible aspects. Currently there is a shift towards other values like certainty, flexibility, risk, cooperation, continuity, energy and attention of management etc. Nevertheless there are other intangible values thinkable that could gain more priority. In this chapter, there will be no exclusive lists of aspects. The main reason for this can be found in the next principle.
3. Business Market Management is the process of understanding, creating and delivering value to business markets and to the customers. In order to be able to create and deliver value, the first step is to understand the business of the client. It is important to get an understanding of what the clients' business values are.

## 2.6.2 Understanding value

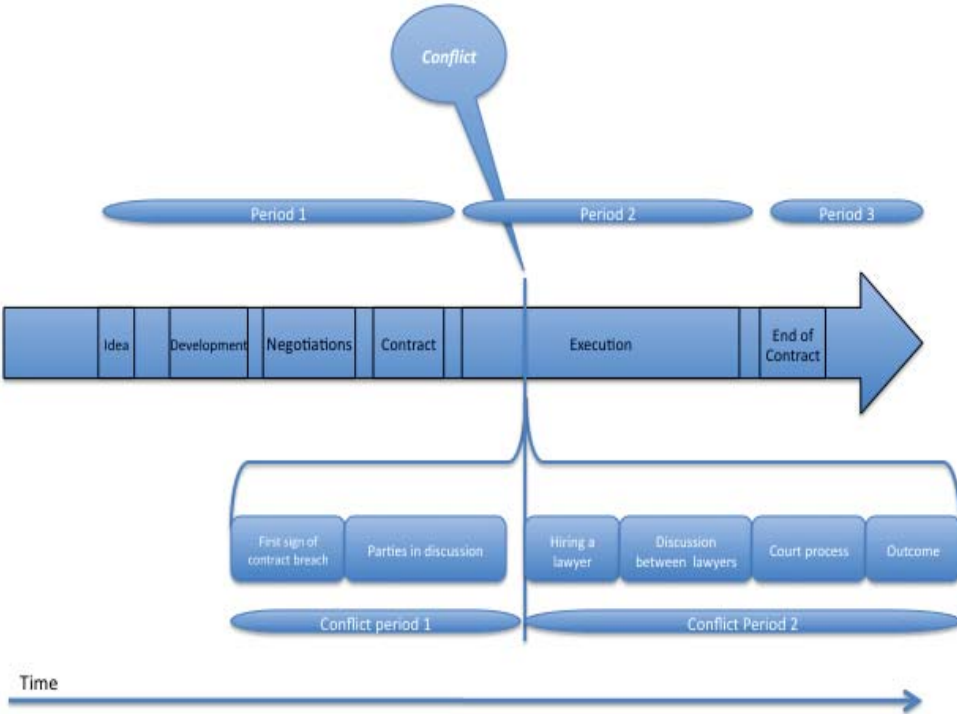
The definition of value for this chapter is the following seen from a legal counsel's customer's perspective:

Value is the total of benefits the customer earns from the service/product delivered minus the total costs the customer has to spend for acquiring the service over a period of time.

Benefits in this equation include both tangible and intangible benefits. The tangible benefits are, for instance, money, time and quantities. The intangible benefits are, for instance, risk decrease, confidence, trust, certainty increase and perceived quality etc.

Where in the past business market management focused on the tangible aspects and thus on a more economic reasoning, today the intangible value is added to this reasoning, and it is sometimes rated even more highly than the economic benefits. In the same way, costs have tangible and intangible elements, both internal and external, that have to be taken into account. Internal costs, for instance, are constituted of time and money spent on information gathering and the preparation of meetings as well as the time spent in negotiations. In addition, the energy and attention that the management of the company (C1) has to pay for acquiring the legal services, execution of a contract with the legal service provider and closing the contract have to be taken into consideration.

The time line in Figure 6 illustrates how the benefits and value will vary during this period. Figure 6 below depicts the life-cycle of contracts between a company (C1) and its client (C2).



**FIGURE 6.** *Different periods of the contract life-cycle.*

The periods from P1 to P3 in Figure 6 will help analyse the most effective way of using legal services. One can distinguish different periods during the contract life-cycle between C1 and C2. Period P1 is the pre-execution process. In this period, the costs and value of legal services differ from the costs and value during the execution period, P2. The same applies to period P3.

**TABLE 2.** *An example of the different periods during the life-time of a contract.*

Period 1 (P1) is the lead-time from an idea till the contract execution starts.
Period 2 (P2) is the time from the execution start till the end of the contract.
Period 3 (P3) is the time after the end of the contract.
Conflict period 1 (CP1) is the time from the beginning of a conflict till the decision to file an action.
Conflict period 2 (CP 2) is the duration of the total court procedure.

In case of a conflict, one can also distinguish different periods. Conflict period CP1 refers to the period before the case is submitted to the court. Conflict period CP2 covers the total court procedure. The costs and value of the legal services also differ between those periods. The important issue here is where the value of legal services can be increased and the total costs decreased. In preventive law, the legal service is focused on the prevention of conflicts as we have already noted. But the most important question remains: what is the period where legal services can assist in order to maximize opportunities or even create new opportunities?

It seems obvious that the answer is not Conflict period CP2. This period can be characterized as minimizing the damage. Even Conflict period CP1 has some negative aspects, because the conflict gains the main focus; however, the prevention of a court process in itself is an achievement. Proactive law and proactive management steer towards the other periods if one is looking for more value and opportunities.

The legal professional's view in each period has to have a future focus. When involved in the first period of the construction of the contract the legal professional has to think of opportunities that are relevant to period 3 (P3)

after the execution of the contract. This means that the contract not only looks at the execution period but the contract has to be written in such a way that future opportunities (and value) can be created for the client (C1). The equation then becomes:

Value P1 plus value P3 minus total costs P1

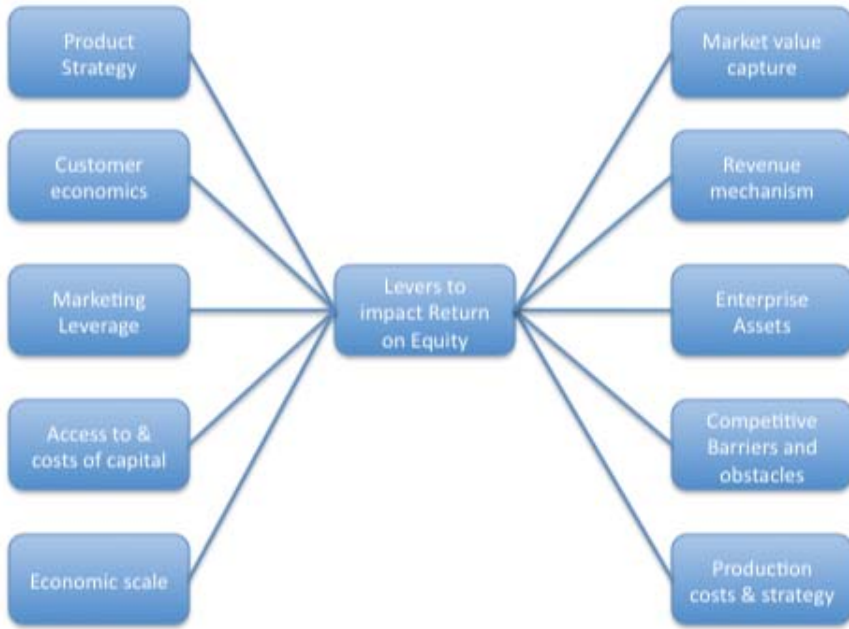
It goes without saying that the value delivered by the legal services will be the higher, the earlier they are involved. In that case the cost of legal service during period P1 becomes less relevant, whereas the opportunities for the legal service business itself do become relevant.

In order to be able to deliver value – according to the definition at the beginning of this paragraph – to the customer (C1) and to be able to earn more value from the legal services delivered, an understanding of the client's (C1) business is the basic requirement. Respectively, the managers (of C1) who commission services from legal service providers have to have a better understanding of the value they can obtain from the legal service business.

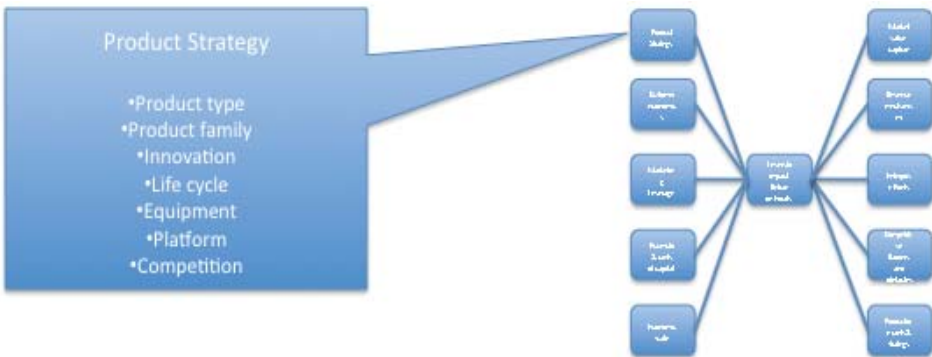
### 2.6.3 Understanding the business

How to acquire an understanding of the business of the client? Although the position of an in-house legal counsel differs from the position of an external legal counsel, the content remains the same. Naturally one might expect that the in-house legal counsel to have more knowledge of the business they work for than an external legal service provider would have. In many cases, however, there is room for improvement. In the situation where a business hires external legal expertise, the requirement to understand the business of the client remains the same. It is wise of the organization who hires a legal expert to communicate a sufficient amount of information on their business of the company to the external expert, and vice versa. It is also wise of the external professional to actively construct an understanding of the business of the client.

The next model (Figure 7) is a tool to get a broad overview of the business of the client (C1). The model is used in real life by private investors with an objective of deciding whether to invest in a company. When talking about value, this is exactly what private investors are looking for – return on equity. In most cases, this is also the same objective the business manager has.

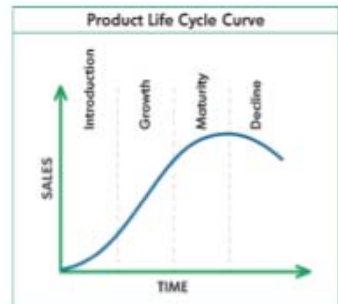


**FIGURE 7.** Basic elements of a business model.



Examples of question to be answered:

- Type; What is the nature of the delivery of the company to the market? Is it a product, service, trade, project, advice, or etc. Is it an end product, component, raw material?
- Single, product line, side products; what are the product the companies is delivering and how do they relate? To what extent is there customization of the product and or service?
- Innovation; is there an R&D, and how much is spend, what are the latest innovations on any area? (e.g. innovation of logistics for a transport company is of mayor importance)
- Life cycle; where on the life cycle curve are the products (and the production facility) positioned? (early start, growth, mature, decline)
- Production equipment (i.a.); what are the key components of the production line, what is the core competence here?
- Platform; Is there a specific platform or infrastructure required for the delivery, application or operation of the product or service
- Competitive products; What are substitutes of the product(s) or services, and thereadd-on's, options, etc



**FIGURE 8.** Example questions.



The model gives an overview of different elements of the business related to the return on equity. Each element has an impact on the return on equity and the different elements are related to each other.

Notes to the model:

- It is a tool to start research on a particular business.
- The model contains the rational elements only.
- The outcome of the research conducted by the legal service provider is not the absolute truth, but a basis for discussion with the different disciplines in a business.
- The outcome of the research and discussions can be placed in a SWOT matrix. (SWOT: Strengths, Weaknesses, Opportunities and Threats.)

This model can be used to analyse a company or a virtual company on a course where business game is used as a teaching method. (See the accompanying teachers' guide in Sorsa 2011b).

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### 3 A PROACTIVE APPROACH TO LAW FOR BUSINESS PROFESSIONALS

*Gerlinde Berger-Walliser*

In the previous parts of this section on proactive law, we have given an overview of the societal changes that take place in the world we are living and doing business in. According to the opinions expressed in part 2.1 and 2.2 of this part of the book, these changes in business and society lead to the need for an innovative, proactive approach to law and management – a paradigm shift. The bases underlying the theoretical analysis of proactive law have been explained above. In the following, we expressly address the non-lawyers: the (future) business professionals, managers, engineers, those in charge of the business deal. In other words, and depending on the perspective, the users of the law, those who “produce value” or “the clients”.

The following is divided into two main sections with several sub-sections. The objective of the first section is to learn how a business professional can avoid getting into legal trouble, in other words dispute prevention. Section two, following the idea of proactive law as prevention, goes beyond prevention and proposes ways for the (future) business professional to use the law strategically as a positive force in the company.

On completion of this part of the chapter, students should have overcome their traditional view of the law and the legal profession. They should have gained an interdisciplinary understanding of (proactive) business law and skills; how to proactively prevent, shift and resolve disputes and how to proactively work with counsel – not to “win cases in court” but to effectively collaborate with lawyers in order to create value for the company. The goal is to prevent litigation from arising and to strategically use the law for competitive advantage and sustainable business relationships. Therefore proactive competences will be developed, such as multidisciplinary analysis, cross-professional communication, networking, creative thinking and outcome orientation.

While this part of the handbook focuses on the law, the problems of today's society mentioned above also call for a change in managerial behaviour.

### 3.1 DISPUTE PREVENTION

#### 3.1.1 Exploring the object of discussion

Think about the following questions: What does a lawyer do? When do you need lawyers? How do you select, hire and pay a lawyer? How do lawyers benefit a company? Probably the impression you have of lawyers is that of a litigation lawyer who fights cases in court as often reflected in (predominantly) US television series or movies. Though there is an obvious entertaining value of this kind of lawyers, we invite you to observe a real court case and to study a court decision. Decide by yourself if you are satisfied with the outcome. Even for the “winning” party, was it really worth the time, costs, and energy? How could the dispute have been avoided? What would be alternatives to a legal dispute before a public court?

Or, you might think of a lawyer as somebody who helps you to stay out of legal trouble by providing an appropriate legal structure for your company's dealings, who drafts contracts and prepares legal documents, in a way to secure your business dealings. But, from a business perspective, should there not be more than that? Do you not expect your employees and your suppliers to provide value to the company? What about your lawyer? Does he or she provide value to your business? If your answer is no, you might want to look for “proactive” lawyers as described in the previous chapter, and explore how you can collaborate with lawyers in order to achieve the desired outcomes.

#### 3.1.2 How can legal problems be avoided

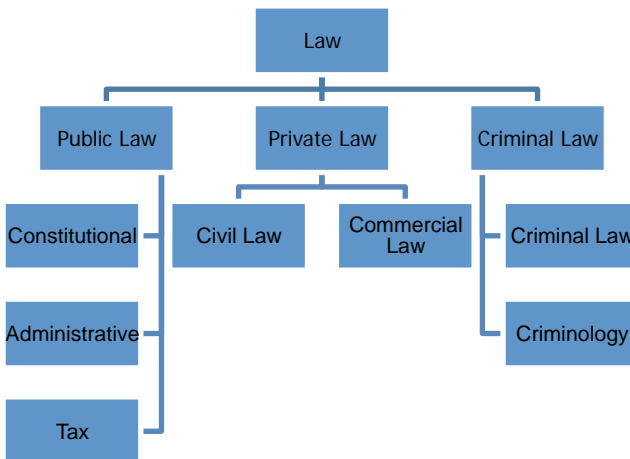
In the following part we propose some (non-exhaustive) ways how legal problems can be avoided e.g. by corporations.

##### 1) Legal literacy

Though it is a simple truth that spotting possible legal problems is the first step to prevent legal disputes, many managers know few or nothing about the law, but instead rely entirely on the knowledge of their attorney. But

how could you call your attorney if you are not even aware of a legal issue, unless he or she “shades” you permanently in all your activities. Therefore any business professional should have a basic legal knowledge that will enable him or her to identify legal issues early and address them with his or her lawyer to prevent legal problems from arising (Bagley 2008). It is beyond the scope of this handbook to give the non-law student a complete introduction to business law. This is the task of a legal environment class. Nevertheless, the legal audit introduced in the chapter that discusses proactive lawyering may enable a business professional with no or little knowledge in law to acquire an awareness of possible legal problems in a relatively short time. In case the legal audit is done in collaboration between lawyers and business professionals, it provides an excellent opportunity to engage in cross-professional learning, and multidisciplinary analysis of the company’s legal strengths and weaknesses.

Typically business professionals and lawyers see things from different perspectives. The business professional looks at business functions, while the lawyer looks at different areas of law. Basic legal areas can be distinguished as follows (Figure 9):



**FIGURE 9.** *Areas of Law.*

All these areas can affect a company’s dealings by imposing duties, such as taxes, criminal law, environmental regulation, employment laws, security standards etc. that a company has to respect in order to avoid exposing itself to criminal prosecution or administrative fines, which can lead not only to

expensive penalties, but in extreme cases to the closing of the company or imprisonment of its officers or personnel. On the other hand, the law can convey rights to a company or protect a company from fraudulent behaviour of others. By not using those rights due to a lack of knowledge companies miss valuable opportunities and consequently lose a lot of money due to ignorance of the law and a lack of legal strategy.

### Example

Most countries' laws provide legal protection for intellectual property (IP) rights in the form of copyrights, patents, trademarks etc. to individuals and companies. Many of those rights require some form of registration in order to be protected. If a company does not protect an invention at all or not early enough, a competitor may commercialize the same idea before the inventor gets the product out on the market, and therefore deprive him from large parts of the market. In some countries "prior art", which means any form of public disclosure of the invention prior to the patent application hinders the inventor to register the patent later. In these countries (e.g. the United States of America) it is crucial to have a confidentiality agreement signed before speaking to a possible investor about the invention. Also the choice of the appropriate form of IP protection determines the future economic use a company can make of an invention. A patent for example makes the invention publicly available to others, but prevents others from using the invention without authorization of the inventor and therefore can offer a strong IP protection.

However, a patent is limited in time (in many countries to 20 years). After that time period anybody has the right to use and commercialize the patent for free. Therefore many different factors determine if a patent is the appropriate protection, or if the company rather wants to take any possible steps to keep its invention secret in order to prevent others from using it longer than the 20 years. Possible factors guiding a company's choice for or against patent protection are:

- 1) the type of invention
- 2) the financial and organizational possibilities for the inventor to commercialize the invention
- 3) how easily it can be imitated or reproduced based on reversed-engineering
- 4) the future use a company wants to make of the invention.

Probably the most famous example where a company deliberately refrained from patent protection in favour of using a trade secret is Coca Cola's legendary secret recipe.

A contract, a private regulation between two or several economic or private actors and the smallest legal unit, typically conveys rights and duties to all parties to the contract. Typically lawyers, judges or arbitrators come into play, when one of the parties does not respect his or her duties, the contract does not reflect the real expectations of the parties who signed it, or the contract turns out to be unbalanced or even abusive. In order to prevent contract litigation and in order to create economic value for both on tract partners, proactive lawyers and managers need to make sure that those legal risks do not materialize.

A legal audit and proactive legal business scan can help identify a company's legal strength and potential legal problems, and help develop legal strategies for all managerial functions.

## **2) Relationship between law and ethics**

A possibility for business professionals to prevent litigation is to engage in ethical behaviour (Lampe 2008, 227, 237–240). Ethics and social responsibility have become an important issue in management, and many business students are well-trained in those subjects. Law and ethics are intertwined and frequently overlap. It would be false to believe that obeying the law equals ethical behaviour. Though many laws are based on moral considerations they often fall behind ethical standards. As Lampe (ibid.) puts it: "Law is a starting point or minimum for ethical behavior", but lawyers are trained to go to "the edge of the law" on behalf of clients. [...] in many circumstances it is legal to lie to one's family or friends, but it is usually unethical." Therefore usually "an ethical person does more than the law requires and less than it allows" (Josephson 2002). Engaging in ethical behaviour can be an appropriate way for business people to prevent litigation, and even going beyond.

## **3) Proactive risk management and insurance**

Legal responsibility and litigation are one of numerous risks a company faces, and therefore should be included in a company's risk management. Risk management is a common course in business schools. In short, it is about identifying and assessing risks, preventing the risk from materializing, and consequently

preventing financial losses. Risk management includes risk transfer, which is shifting the risk outside the organization, and risk monitoring including control and follow-up.<sup>74</sup> Just as risk management includes insurance, legal management should include dispute prevention and insurance. As Professor Lampe points out, “purchasing insurance is a way to protect against many different risks including tort liability of the firm.” (Lampe 2008, 242). Insofar “the function of risk management has much in common with the practice of preventive law”, (Brandt et al. 1997, 159) and legal risk management can be an effective way to prevent litigation.

### 3.2 AN INTRODUCTION TO LAW AND STRATEGY

Staying out of legal problems and working with counsel is one thing, using the law strategically for the advantage of the firm is another. According to Bagley:

*Managers who view the law purely as a constraint, something to comply with and react to rather than to use proactively, will miss opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm.* (Bagley 2008, 378–379)

Bagley is a co-founder of what has been labelled the “law and strategy movement” in the U.S. (Bagley 2010, 587)<sup>75</sup>, a research stream among business law scholars, which can be identified since 2000, and which tries to integrate legal and strategy research. (Siedel 2000, 711 and Bagley 2008, 378–379). For a long time proactive law and law and strategy have developed separately, and at first sight this U.S research stream and the European proactive law movement seem to emphasize different things: competitive advantage on the one hand, preventive and proactive behaviour, and a shift in legal thinking on the other hand. But the quote above illustrates that they have a lot in common. (Siedel & Haapio 2010, 641, 666). Accordingly an article published recently in a leading US Business Law journal finally attempts to merge both research streams. (Siedel & Haapio 2010, 641).

Strategy is a familiar topic to business students and consumes up to a quarter of executives’ available time (Cavenagh 2000). Almost all fields of management

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74 See generally Lampe 2008, 227, 240–242, quoting Christopher L. Culp 2002, *The Art of Risk Management*, 200–205.

75 For a systematic overview and a comprehensive theory of law and strategy see Bagley 2010, 587.

have been studied extensively from a strategic perspective; all besides one – law. However, according to a survey among business executives attending management development programmes, law ranks among three most important business topics, along with human resources and finance (Siedel 2000). The reason is self-evident: with few exceptions, lawyers are not trained in strategy, and managers or strategy scholars have no or little background in law (Bird 2008, 3–4). Therefore law probably remains “the last great untapped source of competitive advantage.” (Downes 2004, 19).

### 3.2.1 What is strategy

*Corporate strategy is defined by the company’s general objectives and its fundamental courses of action in keeping with its available and potential means, in order to achieve its optimal insertion into the social and economic spheres.* (Menguzzato and Renau, 1991)

The existing law and strategy literature proposes ways how legal resources can serve as a basis for strategic behaviour. It draws on well-established management literature, such as Porter’s five forces that shape the competitive environment or Barney’s framework for analysing resource attributes for sustainable competitive advantage, and applies these theories to legal strategy. (Bagley 2010, 587 citing Porter 1980, 3–33; Bird forthcoming 2011, citing Barney 1991, 102). Insofar it provides a theoretical framework and practical solutions to bridge the gap between management and law, and to create value for a company through proactive, strategic use of the law and legal knowledge.

### 3.2.2 What is competitive advantage

According to Barney “competitive advantage is a strategy that creates value that is not already being implemented by any current or potential competitors and cannot easily be imitated in the short term. (Bird 2008, 25 citing Barney 1991, 99, 102). Barney’s framework can be summarized in four questions:

1. Does the resource possess value – for example does the resource allow the firm to act more effectively and efficiently? (Bird 2008, 26 citing Barney 1991, 99, 106)
2. Is the resource rare in the sense of being unavailable to some or all competitors? (Bird 2008, 8–9 citing Barney 1991, 106–107).



3. Is the resource imperfectly imitable because, for example, of unique historical conditions? (Bird 2008, 8–9).
4. Is there a lack of equivalent substitutes – an inability of competitors to copy a firm’s resource? (Bird 2008, 12 citing Barney 1991, 99, 106).

By applying this framework to law University of Connecticut Professor Robert Bird reaches the conclusion that law is a viable source of competitive advantage.

The following examples illustrate how companies can use the law strategically:

### 1. Litigation strategies

A company can voluntarily choose between litigation or alternative dispute resolution. The table below shows advantages and disadvantages of litigation versus alternative dispute resolution.

**TABLE 3.** *Advantages and disadvantages of litigation.*

The disadvantages of litigation	When litigation is preferable
Delay	To establish a legal precedent
Cost	To publicly prove truth
Publicity	Potentially higher damages due to jury trial in common law countries
Negative effect on relationship	Serious crimes or public policy issues involved

A company can decide to favour settlement of cases over litigation, or the other way round. While a settlement usually allows to resolve disputes faster and therefore at a lower cost than litigating them to the end, it bares the risk that a company favouring settlement gets sued more easily because potential plaintiffs may believe that they have a chance of reaching a settlement quickly and at low cost. On the other hand, a company litigating all cases to the end sends an opposite signal to potential plaintiffs. (See generally Siedel & Haapio 2010, 641, 644–647).

## 2. Influencing public policy

Probably the most famous example of a company's public policy strategy is the Walt Disney Company, who when facing the end of copyright protection for famous characters, such as Mickey Mouse, successfully convinced the U.S. federal legislator to change U.S. copyright protection laws, adding 20 years to the length of time a creative work is copyright protected, granting the copyright owner the exclusive right to commercialize the work. However, trying to influence public policy – also known as lobbying – is a long and complicated process. Also, not only the lobbying company will benefit from its lobbying efforts, but all companies in the same industry will benefit from the change in legislation, without necessarily having contributed to it. (Siedel & Haapio 2010, 644–645).

## 3. Country comparison strategy

A legal strategy some companies have used successfully is incorporating the company or choosing a specific country for certain business activities because of this country's laws. Luxembourg, for example, is favoured by some French companies because of low tax rates, and many ships sail under Panamanian flag because of Panama's liberal labour laws. Many companies have been attracted to China not only because of lower labour costs, but also because of its labour laws and lower environmental standards. German law is known to be more seller-friendly than French law, a fact that induces some French sellers to favour German law above their "own" French law when drafting French-German sales contracts.

Nevertheless, because of globalization, the differences in law-related country comparison in regard to competitive advantage start to diminish, at least in some areas. States try to harmonize the law by drafting international treaties in order to do away with different regulatory standards, which hinder free trade. The law of the European Union is one example. On an international level, the Convention on Contracts for the International Sale of Goods (CISG) unifies the international sales law for commercial sales in currently 74 signatory countries, just to give one example. At the same time, international sales law acts as an example where despite of a trend towards legal harmonization, companies can still use a law-related country comparison for purposes of competitive advantage. This is because contract partners can opt out the CISG, therefore if one or both parties find that a certain national law serves their business purpose better than

the rules the CISG provides, they are free to choose a different national law to govern their contractual relationship. Such a decision requires an in depth knowledge of international sales laws and collaboration between lawyers and those who implement the contracts drafted by them.

Also, national laws influence each other. Product liability theory, for example, has originally been developed in the U.S., the European Directive on product liability from 1985 and subsequent national European laws take up strict liability as developed in the U.S. product liability theory. Taking into account globalization and vanishing barriers between states due to the internet, courts and legislators increasingly try to hold companies and private persons accountable for illegal or unethical behaviour in foreign countries. For example, numerous famous brands such as Nike or IKEA have faced problems due to allegations about the use of child labour somewhere in their global supply chain.

Internet cases such as a case filed against Yahoo in France for the sale of Nazi items on its internet auction site (see supplementary teaching material), or litigation against eBay for secondary trademark infringements in Germany, Austria, France, Belgium and the U.S. with sometimes contradictory outcomes<sup>76</sup>, are interesting examples of the vanishing legal borders due to e-commerce. But they also show how countries, despite the increasingly “borderless” society, try to uphold individual national standards sometimes in opposition to legal standards in another country. (See Yahoo case, supplementary teaching material)

#### 4. Changing management’s attitude towards the law

Traditionally managers think about the law as a burden, something they have to comply with, rather than a competence or capability that can add value to the company. Companies who adopt a different attitude towards the law will be able to use the law as a source of competitive advantage. Robert Bird differentiates between attitudinal variables and attributive variables that relate to the development of legal strategy (Bird 2011, 14). In case a company educates its managers in law through legal training and workshops, for example, integrates legal considerations in its management decisions, or deliberately employs people, who have a proactive attitude towards the use

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76 See generally Kurt M. Saunders and Gerlinde Berger-Walliser, The liability of online markets for counterfeit goods: A comparative analysis of secondary trademark infringement in the United States and Europe, *Northwestern Journal of International Law and Business*, Volume 32 (2011/2012 forthcoming).

of law in the company, these decisions could be qualified as an attitudinal variable to develop a legal company strategy.

Attributive variables concern characteristics “of the organization or of the people employed by it,” (Bird 2011, 21–22) for example, the decision to nominate a lawyer CEO of a corporation, the number of lawyers on the board, or to employ an in-house counsel, rather than delegating all legal affairs to an outside law firm. Often companies do not employ a lawyer full-time in order to save costs. The disadvantage of working with a lawyer who is not an employee of the company is that an outside counsel is less connected to the company, does not know the business and the company’s strategy as well as an in-house counsel, and does not have the regular contact to managers and subject matter experts an in-house counsel – at least – could have. Unfortunately the reality in many big companies is that even the in-house legal department is disconnected from the rest of the company and does not get involved in management decisions soon enough. This is often something companies need to change in order to develop a strategic, proactive approach to law. The opposite, a firm’s decision to nominate a non-lawyer as the head of the legal department, also translates as an attributive variable within a firm to develop a legal strategy. But of course, in order to develop a proactive company culture not only managers need to change their attitudes; lawyers need to change, too, and companies need to select lawyers who are willing to integrate management strategy into their legal assessments, and who are able to efficiently communicate with the rest of the company.

## 5. The manager’s legal plan

In his book “Using the Law for Competitive Advantage” (Siedel 2002; Siedel & Haapio 2010) University of Michigan Business Law Professor George Siedel develops a practical tool to help managers to use the law for competitive advantage. The following table (Table 4) gives an overview about what he calls “the manager’s legal plan”. (Siedel & Haapio 2010, 641, 651–656).

**TABLE 4.** *The manager’s legal plan.*

R E A C T I V E	Step 1	Management understanding of the law	Business law courses in management education  In-house training  On-the-job training, provided by in-house counsel working with managers on a specific project
	Step 2	Coping with legal concerns	Settle legal disputes  Choosing the appropriate dispute resolution methods by weighing costs, loss of time, damage to reputation  Doing what is required by the law or the courts
P R V E N T I V E	Step 3	Developing strategies and solutions to prevent future legal problems	Reflect on knowledge gained from Step 2  Designing legal strategies to prevent future litigation. If this is not possible,  Limit liability (for example creating a legally separate subsidiary for activities that may result in similar claims, develop disclaimers, contract clauses that limit liability where legally possible)  Review processes  Develop a general dispute resolution strategy for the company  Develop an anti-dispute escalation mechanisms
P R O A C T I V E	Step 4	Reframing legal concerns as business concerns and opportunities	Developing strategies going beyond the legal requirements in Step 2 for business reasons, for example setting up an ethical charter, code of conduct to remediate image or customer loss  In connection with a lawsuit develop a communication campaign to attract new customers  Searching for foreseeable legal problems and use them as business opportunities (e.g. search for possible misuse of a product that could give rise to product liability in order to develop products costumers need)  Use actual or potential legal problems for purposes of developing costumer service  Creating collaborative contracts that serve both contracts partners better, improve the contractual relationship, create long-term partnerships and save costs

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## III PROACTIVE CONTRACTING AND RISK MANAGEMENT



# I INTRODUCTION

*Kaisa Sorsa, Tarja Salmi-Tolonen & René Franz Henschel*

Over the last few decades, the world economy has shifted from being driven predominantly by single enterprises to being driven by networks of enterprises exchanging goods and services on a large or global scale. In these networks, contracts are relied on to form and govern transactions, to communicate with stakeholders, to manage opportunity and risk, and to execute key business strategies concerning, for instance, innovation or corporate social responsibility.

The restructuring from the single enterprise model to the networked economy model together with the shift from sales to services have changed the role of contracting (Sorsa & Salmi-Tolonen 2006). Instead of primarily forming less complicated one-time sales contracts, companies are increasingly forming long-term relationships and complex contracts based on an idea of exchange of innovation and value creation within the network. Consequently contracts need to be flexible, because they are subject to changing circumstances especially in long-term and life-cycle contracts. This development forces companies to change their conception and attitudes to contracts and contractual relationships to manage both opportunity and risk.

In order to achieve success in the networked economy, companies need to set the focus of contracts beyond the traditional and static definition of rights, obligations and indemnities. The focus needs to be on business goals and success, on relationships, communication and information exchange between parties, and on considering how value is best achieved throughout the contractual relationship; in other words, on people, processes, practices, tools and methods involved ensuring the efficient exchange and development of values in the network of enterprises (Sorsa 2006; Sorsa 2009b). This novel approach to contracts as value-adding components in the networked economy is called *proactive contracting*. This approach sees the contract and the processes related to it as parallels to the internal processes of a company, which also require leadership, strategies, planning, communication, and teamwork. Consequently contracting is a way of seeing contractual relationships as a

particular form of the organization of a firm and contracting as a governance form for optimizing business results in the same way as management theory sees the ways and means for optimizing companies' goals and resources.

In addition, it is essential for enterprises to focus on managing risk in the process of exchanging goods and services in the network. Risk management is a proactive activity that aims at avoiding risk from materializing and developing into real crises. However, used in the right way, risk management is not only about managing risk and avoiding crises, but also about how to avoid exercising risk management in a way that would block opportunities and ultimately endanger the successful outcome of a business relationship. Thus, risk management is an integral part of contracting.

Furthermore, opportunities created throughout the contractual relationship – for instance, services to be delivered in a better, more efficient way, if only the contract terms allow flexibility for adjusting service levels – must be pursued without hesitation. Such improvements can be seriously obstructed if contracts are too formalistic and non-flexible. In the quest for business success, contracts and contracting play important roles in balancing risk and opportunities. Contracting, risk management, and opportunity management are therefore closely intertwined.

Specific disciplines on how to best achieve the desired business outcomes through proactive contracting and risk management have been developed. Contract management focuses on optimizing the managing of contractual relationships, for instance, in sales and procurement contracts. It is an interdisciplinary approach that demands outcome-orientation and cross-professional communication with the stakeholders in order to accomplish desired goals. Contract management has both a strategic and an operational aspect, which must both be taken into consideration for gaining optimal results. Contract management is thus enabling proactive management and proactive law in the broadest sense, and therefore essential to proactive contracting and risk management as will be shown in the current chapter.

In this part III of the book, the focus will be on proactive contracting in addition to risk management and the knowledge, attitudes and skills needed

in order to ensure the avoidance of unnecessary risks and the quest for better business success and opportunities.<sup>77</sup>

In chapter 2, the concept of proactive contracting and the core knowledge, attitudes and skills that ensure the use of proactive contracting for value creation will be explained. In chapter 3, the role of legal environment for proactive contracting will be explained and the different functions of contracts discussed. In chapter 4, proactive contracting will be discussed from the value chain management point of view. Contracts as opportunity management and risk management tools will also be explained. In chapter 5, the concept of risk management and the body of proactive risk management knowledge, attitudes and skills will be described and explained. In chapter 6, the role of contract management for proactive contracting and risk management is explained. In addition, a contracting capabilities maturity model addressing the key attributes for evaluating the knowledge, skills and attitudes essential to a company's contract management is introduced. Finally, the concluding chapter contains some points of discussion that will illustrate proactive contracting and risk management in practice.

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## 2 PROACTIVE CONTRACTING

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In this chapter, the concept of contracting and proactive approaches to contracting will be explained. In contracting, the focus is on the development of understanding of the role of the contract in a value chain: how interdisciplinary and cross-professional communication and networking paired with appropriate strategies and innovation *ex ante* can help avoid unnecessary problems and advance the stakeholders' achievement of the desired business goals. Contracting is a broad concept which encompasses not only the documents (the contracts), but also the ideas, attitudes, people, and processes that form the entire strategic and operational approach to managing contractual relationships. Consequently contracting requires interdisciplinary approaches, cross-professional communication, strategy development, outcome orientation, and above all a profound understanding of the role of the contractual relationships in today's networked economy.

To understand fully the relationship between contracts and transactions a proactive approach to contracting and law is required. From a proactive perspective, contracts are instruments for the realization of all different types of transactions:

- consumer-to-consumer transactions (C2C)
- business-to-consumer transactions (B2C)
- business-to-business transactions (B2B)
- business-to-government transactions (B2G)
- government to government transactions (G2G).

The proactive view to contracting is a consequence of the fact that the principle of freedom to contract is widely acknowledged throughout the world, which turns contracts into important transactional tools in fine-tuning the legal framework regulating the transactions. Since freedom to contract is at its broadest in the B2B and B2G transactions, the management aspect of contracting is more attractive to these two categories. (Keskitalo 2009)

Contracts can also be understood as important assets to an organization. In fact, organizations themselves can be envisaged as networks of contracts. In economics, this view is discussed under the theory of a “firm as a nexus of contracts”.

Contracts are also important instruments for managing risk involved in different kinds of transactions. In order to fully comprehend this potential one should take a closer look at the relationship between contracts and risks. Risk management is one of the key elements in proactive law, especially concerning contracts and contract law. Generally, risk management means developing company-specific measures and creating mechanisms which can manage estimated potential future risks that threaten companies. Risk management is an essential part of corporate governance (Tieva and Junnonen 2009). At its best, comprehensive risk management can help reach goals, enhance planning, create satisfaction for interest groups, create protection against uninsurable risks and balance profits for several years. Risk management is discussed more in detail below in chapter 5.

The role of contracts in different forms of business management will be discussed and the role of proactive contract management for proactive contracting and risk management explained more in detail in chapter 6 below.

## 2.1 PROACTIVE CONTRACTING AND VALUE CREATION

Contracting is an integral part of doing business in both the private and public sectors. The exchange of products and services always involves some contracting either with consumers, companies or other organizations. A company must handle customer demands, create contract drafts, negotiate the contract, agree on and sign the contract, deliver the right outputs, document the right performance and customer satisfaction, and during and after contract performance analyse whether the agreement was fulfilled and whether there is room for improvement. The same approach must be taken to procurements in order to optimize the supply chain. Consequently developing and managing contractual relationships constitute a key business competence (knowledge, attitudes and skills) required of both private and public sector entities.

However, implementing proactive contracting and the related areas of risk management and contract management, is not an end in itself, but the means to an end. It is essential that all contracting decisions and actions focus on the



outcomes the parties are seeking to achieve. In a business context, that end is generally value creation. This should be the overriding principle behind any contracting strategy or operational action.

#### Example

Amazon.com developed “1-Click” or “one-click buying” to allow online customers to buy instantaneously without re-entering contractual information, such as payment details, delivery address etc. In this way, Amazon created a new business model, and the contract was redesigned in order to fit the business model, e.g. the way standard forms were presented and accepted by the buyer (e.g. the development of the “click wrap” acceptance of standard terms, whereby the user must accept the terms by clicking a yes-box).

Furthermore, contracting encompasses the principle that contracts and their management are not an isolated function belonging to the legal department, in-house counsels or legal counsels alone. Contracting is organically and inter-dependently linked to other organizational functions such as sales, finance, marketing, accounting, production, customer relations management entity with other entities in the network and the customers, for instance, in the following regards:

- Marketing of certain product qualities > creates expectations in the recipient > expectations become concrete when the drafted contract clauses are related to product quality.
- Accounting decisions reflect on the pricing decisions of the company > price is an important element for the buyer > price clause is one of the key contract clauses.
- Production processes are also becoming more important from the contract content viewpoint, when more and more products are manufactured or produced in the developing countries. Product and process-related standards are mediated via contract clauses from the developed country buyer to the developing country suppliers.
- Human resource management is an issue raised in global value chains. Process standards also aim at tackling the worst problems of labour abuse (CSR etc.) also from a marketing point of view (company reputation).
- Contracting includes relational aspects, which are increasingly reflected on contractual clauses, e.g. in collaboration and information duties clauses.

The many dimensions and stakeholders make contracting an extremely challenging task. Its multifaceted character also creates a need to analyze contracting from several points of view in order to define the needs and expected benefits from contracting. This requires proactive skills and competences.

### Example

A company has analysed its needs and expected benefits of developing contracting capabilities in the company. The top management primarily pursues corporate governance goals and risk management goals. The middle managers pursue managing and control goals in order to achieve the goals defined by the top management, namely adding visibility to the contract portfolio risks and the individual sales peoples' results. The sales personnel want to use more time on sales-related activities, and maximize relations and outcomes. They want tools which enable them to do this. Consequently, the complete analysis may involve theory and methodology from several disciplines, such as corporate strategy, corporate governance, organizational design, change management, contract management software etc.

For more than two decades the concept of proactivity has attracted much attention within the domain of organizational behaviour and work psychology. The proactive contracting and risk management approach to contractual issues draws on research conducted especially in the field of proactive behaviour in job performance, leadership and work teams and in the field of proactive contracting.

Knowledge, attitudes and skills relating to proactive contracting and risk management can enhance an organization's performance. On the same note, contract management is needed in order to capture and transfer the individual competences to organizational competences and capabilities that can ensure the proper success in business relationships.

## 2.2 FOUNDATIONS OF THE PROACTIVE CONTRACTING CAPABILITIES

Knowledge, attitude and skills together constitute an individual competence. It could be postulated that knowledge is a prerequisite for acting in an adequate manner (skill) in meeting the demands of contracting or other functions in an organization. When we talk of knowledge in this sense, we mean awareness of

and insight into planning, prioritising, and evaluating the use of preventive and proactive measures in contracting.

Competence and capability are terms used interchangeably in relevant literature. Both terms describe the factors beyond the success and performance of the firms, beyond their competitive advantage. Capabilities are formed through resources and competences, and therefore these concepts need to be clarified first.

### 2.2.1 Competences and capabilities

Capability can be defined as the ability to identify, expand and exploit a business opportunity, which is strongly related to the accumulation and development of competences through the path of learning and innovation. Capabilities refer to the organization's ability to deploy resources; thus capabilities are organization-specific, tangible and intangible processes that are developed over time through complex interaction between the organization's resources (Amit and Shoemaker, 1993). The aspects of competence and capability could be summarized as the competence that refers to individual knowledge and skills of human resources rather than capability, which refers to the firm's ability to fulfil its tasks.

Contracting capability is a company's competence in tapping collective skills and learning. It affects allocation of resources in the firm, utilises different types of contractual tools and opportunities and helps achieve business goals. Contracting is a complex and multifaceted phenomenon and contracting capabilities too wide an area to be discussed as one big entity. Therefore, we identified four different areas of capability which together constitute organizational capabilities in a research project involving several companies doing world-wide business<sup>78</sup>. The four distinct capabilities are contract contents, contract process capabilities, relational capability, and organizational and personal proficiencies. Contractual capability as organizational and personal proficiencies defines the loci of the capability – the company or the individuals who have been assigned the contract-related duties and interests. It is the company that obviously needs to possess corporate contracting capabilities, but a company is a body whose knowledge and skills can only be incorporated in and generated by individuals. (Salmi-Tolonen 2008, 3 ff.)

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78 Funded by The Finnish National Technology Agency, LIITO 2006.

One important purpose of proactive contracting is providing means for an early identification of new business opportunities (the promotive dimension) and early identification of contractual or legal problems prior to their becoming actual conflicts that have to be resolved by courts or arbitral tribunals.

### Example

An automobile producer had registered and tracked all customer complaints regarding manufacturing problems with their cars. The prime purpose of the defect tracking was to improve the quality of the products and to evaluate the suppliers' quality so that more complaints from buyers could be avoided as early as possible. If it was a particular supplier's product that caused the defect, the supplier was notified in order to improve the quality. This had also contractual implications, e.g. the supplier had to pay compensation for defective products. When analysing all defects together with the suppliers, the Quality Department found that most of the defects appeared within the first two years of the product's lifetime, in other words, when the seller had to remedy the defects free of charge according to mandatory law. At the same time, marketing surveys indicated that the average time a buyer owned a car was 5 years and the average kilometres the buyer drove was 150,000 kilometres. The Quality Department could also see that the number of defects were occurring in cars older than 5 years and having run more than 150,000 kilometres. In a meeting together with the Marketing Department, the Quality Department, the Legal Department, key suppliers and the top management, it was decided, that the cars should be specially marketed and sold with a "5-Year Warranty/150,000 kilometre maximum" without increasing the risk of losses on defects significantly while at the same time creating the potential for winning new customers as the majority of other automobile produces only gave a 2-year/100,000 kilometre guarantees.

However, based on the statements of the engineers from the Quality Departments together with the Legal Departments considerations, this guarantee required the car owners to come in for a free of charge, proactive service check at an authorized dealer every 12 months in order to detect potential defects. The customers also had to maintain a full service book and to use recommended, original spare parts. Although the Quality Department would have preferred only original spare parts to be used, this was not possible due to competition law restraints, the Legal Department advised. In the first year after the new campaign, the sale rose 26%. When customers came in to the free service check, the contact was kept between the customer and the automobile producer, which increased product loyalty. Also, more original spare parts were sold than before, despite the free choice of the customer warranted by

competition law. This was probably due to the relational tie created with the customer based on the 12-months' free service check. The suppliers received their part of the increased revenue according to the contract which rewarded them with higher prices, if products did not fail. They also enjoyed higher sales volumes. All in all, this was a win-win situation for all involved.

It is therefore important to observe that contracting combines the competences of different employee groups – marketing personnel, engineers, managers and quality experts are all engaged in contracting. Argyres and Mayer (2005a) note that managers and engineers are the primary carriers of a firm's contract design competences and capabilities, contract content capability in our terminology, with respect to the assignment of roles and responsibilities of the parties to a contract and in providing for effective communication processes between the parties.

The lawyers' role is more pronounced in the design of contract terms which govern dispute resolution and which allocate decision and control rights to the parties (Argyres and Mayer 2004). However, as the example above shows, lawyers should also participate in the service planning and design, for instance, when restricting the quality department's demand of only using original spare parts, due to competition law restraints.

The purchasing or procurement function is also an increasingly important part of an organization. Buyers carry competences related to the purchasing process activities and negotiations. From the buyer's perspective strategic and process management, decision making as well as quantitative and logistic issues are elements of the proactive contracting competences. The buyers' personal competences are knowledge and skills related to the know-how concerning supplier markets, analytical skills and the use of performance measurements. This information has to be shared and addressed in the contract together with the legal department or a legal counsel. Purchasing personnel require skills in strategic thinking, communication (written and spoken), negotiation and teamwork, change and customer management, leadership, decision making as well as learning. Organizational knowledge base includes the technological capabilities and the knowledge of customer needs as well as suppliers' capabilities (Peltola 2009, 23).

Contracting capabilities have so far been seen as a separate capability, not aligned with the other capabilities of a company. Contracting capabilities are dispersed within organizations, usually assigned to lawyers and not managed

similarly to the other functions of the company. Managers do not necessarily understand the relevance of contracting capabilities and therefore the topic has not been in the focus of managing. Neither have there been tools to help manage the contracting capabilities available – such tangible tools as a maturity model. Managers need to understand that managing contractual relationships is as important as managing the company. The economic significance of corporate contracting capabilities is increasing rapidly, as companies seek new ways of managing partnerships and other critical business relationships, especially in service business. (Salmi-Tolonen 2008, 3 ff) Traditional supplier-buyer contracts no longer suffice when greater profitability is sought through enhanced collaboration (Sorsa 2009b).

Personal competences highlight the personal qualities and proficiency and the set of behavioural characteristics of a person, but is not a part of an organizational inventory. An organizational inventory is constituted by organizational capabilities defined by processes, systems, and practices (e.g. training methods, performance appraisal, reviews, change programmes etc.) that enable any firm to turn personal competences into organization-wide capabilities – they may also be transformational by allowing the firm to change and grow simultaneously as Murray (2003) has pointed out (Sorsa and Salmi-Tolonen 2009). The example of the 5-year/150,000-kilometre guarantee above demonstrated how significant combining different knowledge, capabilities and competences can be. Without the right processes for interdisciplinary and cross-professional communication and networking, however, the idea might never have been borne.

### 2.2.2 Organizational contracting capabilities

Studies have shown that there is a range of generic and specific capabilities needed in contracting. Corporate contracting capability on contract contents is related to knowledge and information possessed and generated within the company. Knowledge generated within the company is manifested particularly in contract design, i.e. drafting the contract structure for it to serve its purpose optimally and effectively. This capability includes various types of knowledge on how to manage the company's contracting in respect of assigning roles and responsibilities to the parties, conferring control and decision rights, and understanding and managing future contingencies. This knowledge is not limited to any particular type of contracts (Salmi-Tolonen 2008). This

knowledge has also impacts on the design, processes, tools etc. that are used in risk and contract management (see below).

### Example

In the automobile guarantee example above, a prerequisite for claiming the guarantee is a full service book kept by the customer. If the service book is lost, the customer has to give proof and guarantee that the book is lost. If the automobile producer were obliged to keep the records, this problem would not even arise. However, the risk is borne by the customer based on the different considerations, e.g. costs of establishing a complete central record, that a central record is not possible due to the fact that competition law may be breached (customers may choose non-authorized companies to conduct the service and repair), and that cars are sold further and consequently new owners would have to be registered etc.

Contract process capability is a capability of a company to manage the contract negotiations both internally (intra) and externally (inter). This capability is about the company's capacity of conducting business projects. Negotiating and bargaining generally involve a number of participants with vested interest. This is an interactive process that can be standardized only to a certain extent by allocating the roles and responsibilities to the persons who take part in the negotiations. Contract process capability is conditional on the individual competences of technical experts, sales personnel, contract managers and legal counsels in addition to the company presence. It is manifested especially in the adoption of contracting process management tools such as contract process maps, checkpoint flowcharts, and contract document management software<sup>79</sup>. (Salmi-Tolonen 2008, 10)

Contractual relational capability is strongly tied to the company's reputation, market position and consequently its presence. It is manifested in the company's capacity to sustain cooperation and end the relationship. This is a capability of a company to manage the process of communication and cooperation between contracting parties, including the means of resolving the disputes – litigation, alternative dispute resolution methods, mediation, or contractual or non-contractual means of dispute resolution – in case the cooperation fails. (Salmi-Tolonen 2008, 10)

According to Kor and Mahoney (2004, 185) organizational capability is to organize, manage, coordinate, or govern sets of activities, from routines to sustaining competitive advantage. Managers function as catalysts to the conversion of firm's

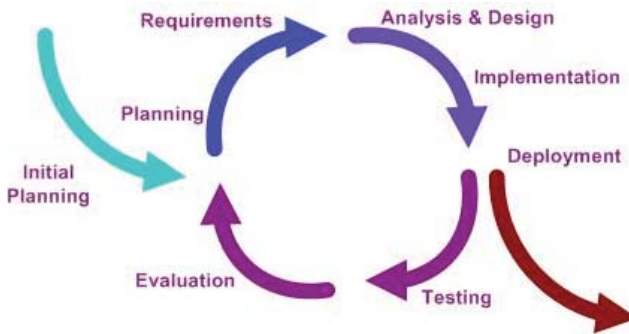
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79 Se generally APICS and Protiviti (2006).

resources into firm capabilities and new product applications. The current knowledge base and underutilized resources like legal and contracting resources of the firm determine the direction of the firm's growth. The capability of a top management team to integrate legal considerations into all aspects of the firm's strategy formulation and execution is a valuable dynamic capability.

### Example

Companies developing software discovered that using new project development methods improved the final outcome. Instead of making a complete and detailed specification before the project start up, the project is developed through Iterations. Iteration is a project that runs over a pre-defined timeframe, usually 1 or 2 weeks, usually at an agreed pre-defined cost, and a general overview of the functionality and goals of the Iteration. The developers will generate as much functionality and business value within the Iteration as possible in cooperation with the customer. If then the customer have a new idea, which often happens right after the first demonstration, once they have the first working software in their hands, they can ask the developers to make it happen. Similarly, if the developers think of a great way of simplifying or improving a process, or add (or remove) an additional feature, they can propose it without recourse. Both parties know how it affects the Iteration, and thus, the bottom line. There is no relying on the old concept of an "change-order", and the project form allows for a rapid-feedback-loop securing that what is being developed by the developers is exactly what the clients want. New Iterations are based on the experiences of the former Iteration, and so the product is gradually developed. The illustration below shows the development model.



**FIGURE 1.** *Iteration model. (Illustration taken from Wikipedia, Commons license.)*



In contrast to waterfall models or similar models, where the business value is supposed to be delivered at the end, all at once, and based on a well-defined contract with exact specification of the to-dos and the hows, in the Iterative model, the focus is on the what (not the how) on the business output, and on how to get the project to work in collaboration with the customer. Consequently, the type of contract needed closely reflects the partnership and project model – for instance, no detailed SOW (statement of work), advanced information and collaboration duties, maturity tests and documentation on Iterative experiences, right to change specifications, (if it does not fundamentally change the obligations of the developer), proactive duties to inform about changes in the key personnel involved in the project and right for the other party to ask for similar competences etc. In short, contract content, contract process, relational tools, and organizational capability tools are implemented in the contract in order for the contract and related processes to be aligned to the business model – not vice versa!

As indicated above, contracting is about understanding the role of the contract in business. It is an inherent part of the business strategy and each business model needs its own contract model. Furthermore, it is the concern of the whole company and not only lawyers. Consequently multidisciplinary analysis, cross-professional communication and networking, creative thinking and outcome orientation are important. The contract is the foundation of a contractual relationship, but the contract cannot stand alone.

Proactive contracting is built on the use of contracts as proactive tools. It is not predominantly about the law or lawyering. First and foremost, it is about the conscious use of contracts and contracting processes as management tools, which guide and support the success of the company's business (Haapio 2006, 153). This viewpoint takes law and legal rules as given facts, the backdrop against which the contractual relationships are developed.

We can talk about both hard law and soft law. These terms are self-explanatory: hard law refers to mandatory provisions and soft law to enabling provisions. In contracting, private parties are to a large extent able to create the legal framework by themselves (freedom to contract), but at the same time, the parties must comply with mandatory rules. If we look at private regulation in business, we can say that proactive contracting uses contracts as promotion tools for best practices, such as raising the quality standards above the requirements of the law (Sorsa 2010c).

## Example

Suppose that the automobile producer in the example above, is able to push the competitors to introduce a five-year-warranty generally in the automobile business. In that case, the mandatory rules that give a two-year warranty suddenly seem inappropriate. If this trend continues in private regulation, the public law maker will realize that the mandatory rules might have to be adjusted to give more than a two-year warranty. Thus the private actors have raised the bar, and the public law maker will follow them.

At the same time, proactive contracting also seeks to find the limits of contracts and alternative instruments, which will work to supplement or replace contracts. This can be seen in the way industry self-regulation, business ethics and standards are developed.

## 2.3 THE ROLE OF BUSINESS ETHICS IN PROACTIVE CONTRACTING

### *Kaisa Sorsa*

Contracting is not merely about contracts, law and mandatory regulations. Companies increasingly try to solve problems proactively by acting in a manner that is seen as standard good behaviour in the industry. Thus, being proactive has connections to responsibility and morality. According to Stone, responsible persons are the ones

*(...) who, at least, think before they act, not only about benefits to themselves, but also about the effects their actions are likely to have on others. They gather and take into account information bearing on distant consequences, on how their choices will impact neighbors and neighborhoods. They weigh alternatives with reference to certain socially sensitive categories that is, "right", "wrong", "harm". If a responsible individual is one who looks before s/he acts, who traces out consequences, the responsible corporation is one whose bureaucratic structure, information-gathering protocols, etc. are similarly oriented (Stone 1985, 17).*

According to Lampe (2006) an important way businesses and individuals can prevent legal liability is by behaving ethically. Today's business environment warrants that managers go beyond mere legal compliance. Society increasingly demands, and business savvy people see the wisdom of, "integrity-based"

management, which combines concerns of law and ethics together by imposing fines on organizations on the grounds of neglecting to undertake proactive ethic activities and programmes. (cf. e.g. PriceWaterHouseCoopers *Integrity-Driven Performance*, A White Paper 2003)

The ethical environment consists of externalities, such as public opinion, legal and political pressure, and the sensibilities of outside stakeholders and constituents as well as the internal atmosphere within a business, as reflected in the attitudes of employees and, ultimately, within the conscience of the individual corporate executive (Stone 1985, 17). Studying the ethical environment entails an awareness of the theoretical systems of morality. But while the traditional study of ethics often ends with the attempt to distinguish good conduct from bad, an ethical environment approach would focus sharply on how managers are to deal with the practical problems that are now being stirred up by the ethical debate (Raisner 1997, 1333).

Understanding what it means to be a responsible individual leads to questions such as how those patterns of conduct can be institutionalized into organizational responsibilities and what those patterns mean from proactive contracting viewpoint.

*If moral competence is to be meaningful, it must be built into the social structure of the enterprise. Thus understood, the corporate conscience is not elusive or indescribable, nor is it mainly a psychological phenomenon. A corporate conscience consists of a specific arrangement for making accountability an integral part of corporate decision-making. The main strategy is institutionalization.* (Selznick 1992, 351–352)

Industrial morality is a necessary part of industry decision making: questioning one's behaviour, knowing what options there are available, thinking through consequences of various choices, recognizing one's responsibility to choose wisely, and so on. Selznick notes:

*The great task of institutional design is to build moral competence into the structure of the enterprise. This is the key to corporate responsibility – private as well as public.* (Selznick 1992, 345)

In proactive contracting, the moral competence issue relates to the question of how normative principles and practices are built into the operative structure of the industry and how they affect contracting. On the one hand, it is a very strategic question, and on the other, a very practical question. Industrial

morality is reflected in the codes of conduct, in the quality standards, in the social standards etc. Industrial morality is a question of institutionalization, which takes place in the broader context of industrial networks. Proactive contracting is a tool to put the institutionalized norms into action. Proactive contracting connects contracting to broader topics of self-and private regulation (Sorsa 2008c).

### Example

Companies that use the Iterative or agile development of software often adhere to special norms of company behaviour that reflect the collaborative and ethical attitude towards contracting they have. An illustration of this is the Agile Manifest<sup>80</sup>. The four main ethical values reflect the core idea:

- Individuals and interaction over processes and tools
- Working software over comprehensive documentation
- Customer collaboration over contract negotiation
- Responding to change over following a plan.

These four main ethical values are sub-divided into 12 software development principles:

- Our highest priority is to satisfy the customer through early and continuous delivery of valuable software.
- Welcome changing requirements, even late in development. Agile processes harness change for the customer's competitive advantage.
- Deliver working software frequently, from a couple of weeks to a couple of months, with a preference to the shorter timescale.
- Business people and developers must work together daily throughout the project.
- Build projects around motivated individuals.
- Give them the environment and support they need, and trust them to get the job done.

- The most efficient and effective method of conveying information to and within a development team is face-to-face conversation.
- Working software is the primary measure of progress.
- Agile processes promote sustainable development. The sponsors, developers, and users should be able to maintain a constant pace indefinitely.
- Continuous attention to technical excellence and good design enhances agility.
- Simplicity – the art of maximizing the amount of work not done – is essential.
- The best architectures, requirements, and designs emerge from self-organizing teams.
- At regular intervals, the team reflects on how to become more effective, then tunes and adjusts its behaviour accordingly.

These four ethical values and 12 main principles capture many of the core values of proactive behaviour. It is important that teamwork and a collaborative attitude are maintained throughout the project. This lays emphasis on organizational proactive ethical contracting competences to support the business goals.

Finally, the development of the Agile Manifest can be seen as a reaction to a crisis between the customer and the developer, which drives forward a need for re-defining the ethical foundation for the relationship between the parties, the way they work together and form contracts together. As the third ethical value states: “Customer collaboration over contract negotiation”.

How do ethical values relate to the legal framework surrounding agile and iterative projects? How can the parties develop agile contracts, and how are the contracts supported and interpreted by court intervention? Does court intervention suit these types of contracts at all? In chapter 3, we will look at proactive contracting and the legal framework.

## 2.4 SUMMARY

The restructuring of world economy and markets calls for new approaches to contracting. The concept of contracting already indicates that we are talking about a wider concept than that of contract law or contract as document. Planning and commitment, execution and termination as part of contracting are closely tied to companies' business models, needs and opportunities as well as business strategies. However well administered, documented and functional a company's contract management system is, it is not worth much, if it serves a wrong kind of business or partnership model. Service planning and productization on the seller side should be seen as an inherent part of contracting as well as needs analysis and procurement planning on the buyer side. Finding the right partners, negotiating and implementing the contract, and communication all through the contractual relationship are all equally important parts of a contractual relationship. As contracting today involves long-term commitments, contracts have to be flexible and adjustable according to the business needs. Communication and cooperation skills are more and more emphasized as risks grow in long-term partnerships. Contracting that takes into consideration all these aspects is proactive contracting.

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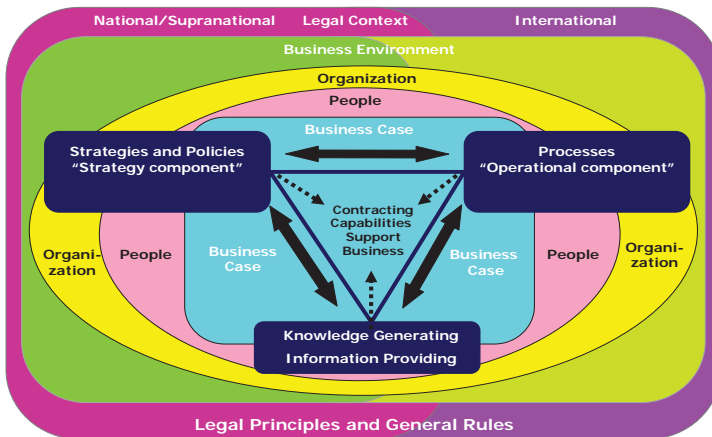
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### 3 PROACTIVE CONTRACTING AND THE LEGAL FRAMEWORK

*Kaisa Sorsa & Tarja Salmi-Tolonen*

In today’s markets, not only companies but also networks compete with each other. In an industrial network, all the members share the responsibility of the continual development of the services and competence they offer. At the same time, networking means a new type of earning logic: the value and benefits generated for the end-customer during the life-cycle of the business activity must be created in cooperation and proven to be of the customer’s satisfaction. (Educating Intelligence 2006, 4)

The legal context constitutes a framework for all business, both in domestic and international markets (the outer zone in Figure 2). The different kinds of legal norms set up the legal framework for the transactions. This legal framework consists of both general and contractual legal norms, where the default solutions provided by the applicable law can be fine-tuned to the needs of the contract parties with the help of the contractual regulation of their relationship. Regulators, investors, business stakeholders and the public are increasing their demands on companies to conduct business with integrity, honesty and trust.



**FIGURE 2.** *Contracting in context (Designed by Lehto and Salmi-Tolonen 2008).*



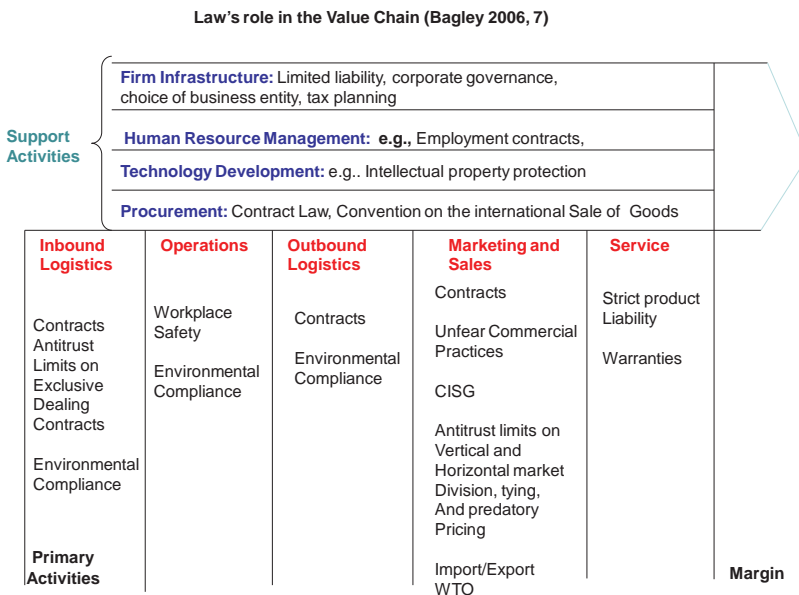
A new way has emerged of seeing the roles of the government and private actors as rule-makers (Zumbansen 2011; Scott, Cafaggi and Senden 2011). Firms are increasingly engaged in activities that have traditionally been regarded as genuine governmental activities. Private actors are willing to take responsibility for social issues, which have traditionally been the responsibility of the government. Many firms have started to assume social and political responsibilities (Corporate Social Responsibility, CSR) that go beyond the legal requirements and fill the regulatory vacuum in global governance. Especially transnational corporations (TNC) engage in public health, education, social security, and the protection of human rights. This occurs especially while operating in countries with failed state agencies: companies define ethical codes and engage in self-regulation to fill global gaps in legal regulation and moral orientation (Sorsa 2009c, 36–39; Porter and Kramer 2006).

The importance of the legal environment for businesses has grown continuously over the last two decades (CEO Survey 2008, 56–57). The role of self-regulation (standardization, codes of conduct, codes of ethics, and general terms and conditions) has become an important part of the daily business especially in an international context. This is due to the responsible business movement, which highlights the importance of the environmental and social issues in global business. From the contracting capabilities point of view, in a multilevel, networked environment, companies need capabilities in order to manage these multilevel rule systems, multilevel networks and capabilities to use other tools (Bagley 2005, 15), in addition to contracts, in order to manage all the relevant relationships with their different stakeholders. This emphasizes the importance of the broad view to contracting capabilities encompassing different tools (contracts and self-regulation) produced by other actors known as “private law makers” or “private rule makers”. (Sorsa 2008c; Sorsa 2011a)

An example of this is found in Denmark, where law firms have developed standard form contract templates fit for iterative or agile projects, and they can be freely downloaded from the internet. The law firms have been participating in standardization work involving private as well as public firms and organizations, but found that the time was to develop more agile contracting models. The private actors have decided to publish those in order to inspire others to use agile contracts. The private law maker steps up for action in order to create a new and better way to deliver software systems supported by contract design. This can also be used as competitive advantage for those who dare to take innovative new approaches.

### 3.1 THE LEGAL ENVIRONMENT AND COMPETITIVE ADVANTAGE

Law helps shape the competitive environment and affects each of the five forces identified by Porter (1985) which determine the attractiveness of an industry: buyer power, supplier power, the competitive threat posed by current rivals, the availability of substitutes, and the threat of new entrants. Law affects the internal organization of the firm, including the choice of the business entity, its resources and capabilities (Figure 3). Law also affects the firm’s external relationships with customers, suppliers, competitors, and complementors – in other words, those players who cause customers to value another firm’s products and services more. Law affects each activity in the value chain. (Bagley 2006, 6–7)



**FIGURE 3.** Law’s role in the value chain (adapted from Bagley 2006).

Law and business form a system in which law affects the market and market players, but the market players also affect the law. Law is not merely a static external force imposed on managers and their firms. Legislation and all the other tools it offers are also an enabling force the managers can help shape and use to manage their firms more effectively. Given the public law’s constraints

and the firm's strategic position within the competitive environment and its internal organization and resources, a legally astute manager can use a variety of legal tools to increase the firm's realizable value and to reduce risk (Bagley 2006, 7–8). This is true especially in contract law where the parties enjoy contractual freedom and are thus free to innovate new contract terms and designs, suitable for the business model in question. The agile contract is such a model designed to fit “Iterations” in an agile process, and not a detailed Statement of Work, as is the case in the traditional “Waterfall” projects. There is no statutory law that suits such contracts – only Sales of Goods codes, which do not fit service contracts all too well, such as agile software contracts.

In contract law, there has traditionally been a division between contracts for the selling of goods and for providing services. However, at the time when in most countries the domestic Sale of Goods Acts were drafted, economies were primarily based on the manufacturing and supplying of goods. Sale of goods is covered by sales law, which is usually entitled the Sale of Goods Act, Commercial Code, or the like. In international transactions, the CISG (United Nations Convention on Contracts for the International Sale of Goods) is now known as the “international sales law” of more than 70 countries which account for over three quarters (3/4) of all world trade. There is no similar international law concerning services. The CISG is not applicable, if the “preponderant part” of the obligations of the supplier consists of the supply of labour or other services. Many countries also lack domestic law concerning the sale of services. The general principles of contract law will then serve as gap-filling provisions. If a dispute arises, the existence and contents of such principles can be controversial (see e.g. Rekola and Haapio 2009, 39). Therefore, private actor initiatives, such as the agile contracts mentioned above, can help the law maker and other actors see what the law is, exactly the way as the Sale of Goods codes were once developed against the backdrop of trade usages and practices. The self-regulation initiatives may thus pave the way for new statutory rules (Sorsa 2011a).

In cases where trade disputes have arisen, one of the problems encountered has been the fact that, as a rule, goods can readily be measured in terms of quantity and quality, whereas the measurement or evaluation of the quality and quantity of services is not always that unequivocal. This is the case, in particular, when the contract and the related service descriptions are not clear. For example, what measurement or standard does one use to assess the quality of a service? Failure to develop effective and clear quality criteria or performance indicators for services which are then expressed in the contract documents will present

problems for both the supplier and the buyer. By detailing and clearly describing the services to be provided and designing suitable performance indicators, the KPIs, both parties will be able to determine whether the service provided was what it was agreed to be, and unnecessary disputes can be avoided (Rekola and Haapio 2009, 38). On the other hand, the development of new and innovative services requires that the parties do not over-design the service or contract. This is a contradiction which can be solved by basing the relationship on mutuality, trust and willingness to change according to circumstances.

The development of agile contracts also shows that it is necessary for the parties to understand the role of the contract and contracting process in the business environment as well as the value chain in order to understand how contracts can be designed. The agile contract is a case in point. It is designed to fit the business model and process, and it is not alienated from the business context as contracts occasionally are. Thus, the contract relates to the business processes that need to be established, the maturity of the parties involved in the project, teamwork processes and tools, knowledge generating and information providing.

## 3.2 CONTRACTUAL FUNCTIONS

The value chain perspective highlights the creation of value at different levels of the chain (Sorsa 2009d, 21 ff.). Contracts and contracting can create value. Contracting can have different functions for the different interest groups within an organization and in the value chain. From the business management perspective contracting may be associated with contract administration, whereas business governance perspective would see contracting as a tool for strategic and corporate governance management. A legal management perspective might lead to associating contracting to compliance and risk management aspects, and see contracting as a tool to handle risk (Keskitalo 2009). Thus, it is important for an organization to encompass all these viewpoints in a contracting organization, and not to settle for only one or more focal points while deciding the role and design of the contracting organization.

It is self-evident that different professional groups tend to see contractual functions from different perspectives. Lawyers evaluate the elements of contracts from the point of view of their own training and emphasize the necessity of careful wording of contractual terms and determining which obligations and liabilities are included and which are excluded in the

contractual arrangements. Contract counsels pay attention to mandatory laws and regulatory requirements, and consider pre-contractual promises: whether any were made and whether they are enforceable, they take into account both explicit and implied liabilities and remedies. (Haapio 2006, 156)

For sales managers, a successful business deal and good client relationships take priority over what lawyers worry about and to them everything else may seem obstacles rather than opportunities on the way to closing a profitable deal. A contract counsel should keep in mind that contracts are not mere legal enforcement mechanisms, risk management tools, or something providing evidence in court. In business reality, a contract is always a tool to achieve revenues and profit. Business, technical and financial concerns, relationships and reputation matter more to business people than what is or is not part of the contract. (Haapio 2006, 157)

In today's circumstances, it is necessary to make adjustments to this separation of different professional groups and aim at a new conceptualization of contracts and contracting. Proactive contracting promotes a multidisciplinary approach and cross-professional cooperation where the expertise and knowledge of all different aspects work together towards a common goal – success.

Contracts create a framework for inter-firm exchanges (Llewellyn, 1931) by providing mechanisms to cope with the relational and performance risks that are inherent in all inter-firm relationships (Das and Teng, 1996). There have been recent claims that rejecting the traditional conceptualization of contracts as uni-dimensional legal safeguarding devices is indeed preferable and steps should be taken towards viewing them as multi-functional instruments (Klein Woolthuis, Hillebrand and Nooteboom, 2005).

Eckhard and Mellewigt's (2006) findings indicate that the change towards the multi-functionality of contracts is already a reality. On the basis of the findings, Eckhard and Mellewigt (op.cit.) propose that contracts currently serve three main functions. Firstly, derived from the behavioural assumption of opportunism (Williamson, 1985), relational risk is concerned with the probability that an exchange partner does not comply with the spirit of cooperation and seeks his self-interest instead (Das and Teng, 1998). Thus, the contractual function most prominent in literature is *safeguarding* of investments and property against misappropriation by the partner. Secondly, contracts serve further purposes regarding performance risks. Performance risk refers to the probability that the intended goals of a partnership may not

be accomplished, even though *cooperation* between the firms is satisfactory. The causes of these risks may, on the one hand, lie in the incompetence of partners when faced with complex, uncertain tasks, and on the other hand in the market and technological uncertainties (Das and Teng, 1998). In order to ease the former performance risks to the extent possible, contracts may supply the relationship with a clear definition of the parties' respective roles and responsibilities, thus acting as coordination devices by aligning expectations (Mayer and Argyres, 2004). Finally, to cope with additional challenges that may emerge unexpectedly from the market or technological environment when the collaboration is already under way, contracts have to serve a third purpose successfully, namely the adaptation of the exchange in case of unforeseen events. *The contingency adaptability function* deals with the specification of principles or guidelines in the contract on how to handle such situations (Luo, 2002).

According to research on inter-firm contracts based primarily on the TCE (transaction cost economics) literature, the overall rationale for contracts is to provide an alignment of the expectations and incentives of partners prior to a transaction (Argyres and Mayer, 2007). This is necessary since the parties face considerable uncertainty about the markets and future states of nature and behaviour of the counterpart (Ariño and Reuer, 2004). However, the cost of drafting a contract as an *ex ante* mechanism to facilitate a “meeting of the minds”, according to Ring (2002), should be accepted only if positive returns are expected from it, such as the reduction of uncertainty and *ex post* costs caused by opportunism and assigning blame for problems (Argyres, Bercovitz and Mayer, 2005; Dyer and Chu, 2003). Hence, the degree of detail in a contract is a choice (Crocker and Reynolds, 1993) and should be appropriately aligned with the underlying transaction attributes and the resultant exchange hazards (Williamson, 1991), thus economizing on transaction costs (Saussier, 2000). (Eckhard and Mellewig 2006)

By introducing modern concepts such as the Agile Manifest and agile contracts, the contracting parties try to look beyond the traditional concept of contract and introduce new governance and trust models that facilitate business success. Consequently, the traditional role of contracts is contested and enhanced with new concepts and ideas that have traditionally been performed in a non-formal way by trust and business relationships.

In brief, research on the organization of inter-firm relationships has recently shifted towards examining contractual design. According to Eckhard and Mellewigt (2006, 2), inter-firm contracts serve the above mentioned three distinct functions: safeguarding of the parties' investments, coordination of the exchange process, and contingency adaptability to cope with future disturbances.

### 3.2.1 The Safeguarding function

To protect one's own investments and to manage appropriation concerns contractual provisions can be implemented to enforce the transaction (Dekker, 2004) in order to ensure that the partner complies with their agreed tasks instead of unilaterally terminating the relationship after they have achieved their private goals. This prototypical and prominent contractual function is the *safeguarding function*. Typical contractual provisions assigned to the safeguarding function deal with (intellectual) property rights (e.g. Klein Woolthuis et al. 2005), confidentiality (e.g. Klein Woolthuis, 1999; Reuer and Ariño, 2005), unilateral early termination (e.g. Argyres and Mayer, 2007; Mayer, 2004) and dispute resolution (e.g. Argyres and Mayer, 2005; Reuer and Ariño, 2005). Safeguarding provisions have in common, on the one hand, that they supply incentives to prevent the actual occurrence of opportunistic behaviour, and on the other hand they provide clear guidance in case of breach of contract for enforcing adequate penalties, such as compensation payments, through legal or other institutions (e.g. Klein Woolthuis et al., 2005; Rooks et al., 2003; Cooter and Ulen, 2011).

The safeguarding function of contracts sometimes referred to as an enforcement function or an incentive function is acknowledged by most of the studies discussing distinct purposes of contracts. According to Reuer and Ariño (2005), research findings show that asset specificity, as well as strategic importance and time boundedness, encourage a greater use of such provisions. With regard to asset specificity, evidence presented by Anderson and Dekker (2005) supports the positive relationship, because specific investments encourage the integration of provisions dealing with both "rights assignment" and "legal recourse" which are – seen as a bundle – largely consistent with the provisions shown above and serve the safeguarding function. Since other transaction attributes (task complexity, competition, and power) prove to be influential only for either rights assignment or legal recourse provisions, the result for asset specificity is the most intriguing



finding of their study. In sum, the traditional safeguarding function of contracts is clearly visible and has been confirmed by empirical research. (Eckhard and Mellewigt 2006, 14–16)

### 3.2.2 The Coordination Function

Contracts serve an additional *coordination function* as regards to the performance risk inherent in the task in question. These risk types are clearly distinct from the relational risk addressed by the safeguarding function as the relational risk is a unique feature of forms of inter-organizational collaboration, whereas performance risk is equally present for all transactions, whether completed internally or with partners (Das and Teng 1998). Thus, both partners to an agreement jointly face the performance risk, i.e. the risk of failure to achieve expected outcomes of a transaction because of highly complex, uncertain tasks or a lack of competence to address these challenges. Scholars have stressed that complex tasks to be completed across organizational boundaries pose significant coordination concerns since the division of labour and the interface of activities and products need to be harmonized (Dekker, 2004; Gulati and Singh, 1998).

Thus the coordination concerns refer to the difficulties of aligning actions (Gulati, Lawrence and Puranam, 2005). One of the major drivers of these coordination concerns is task inter-dependence, a construct stemming from the organizational theory literature, highlighting the administrative challenges of coordinating decomposed tasks between partners (Gulati and Singh, 1998). Coordination concerns are particularly high, if a transaction is characterized by a high degree of reciprocal task interdependence involving frequent, simultaneous exchange of outputs between the parties (Thompson, 1967). Task interdependence is especially evident in construction projects or ICT contracts (Sorsa and Salmi-Tolonen 2006). Following organizational theory, the implementation of mechanisms such as contracts is required in order to cope with the coordination concerns (Dekker, 2004; Gulati and Singh, 1998). The new contract design, such as the agile contract developed for iterative software development projects, displays these concerns.

Contracts can play a crucial role in reducing coordination concerns as means of planning collaboration and clarifying mutual expectations of the partners (Tieva 2010; Mayer and Argyres, 2004). This can be done by a clear alignment of the respective roles and responsibilities of the partners. This helps reduce complexity and avoid costly misunderstandings (Ryall and Sampson, 2004).



Contracts can further serve coordination purposes by specifying decision rights, information duties, boundary departments or all other kinds of interfaces between parties (Mellewigt et al., 2005). To sum up, contracts have a highly important coordination function, since they force firms to consider details of their collaboration already at the outset and contracts therefore act as a kind of blueprint or technical aide for the exchange (Klein Woolthuis et al., 2005; Ryall and Sampson, 2004). Contracts can therefore be seen parallel to other internal governance tools in a company, where the same coordination functions, specification of decision rights, and so on, have to be defined.

According to Eckhard and Mellewigt (2006, 17), in comparison to the contractual provisions assigned to safeguarding, provisions referring to the coordination function of contracts are commonly less externally enforceable (Ryall and Sampson, 2004). While the former focus on possible negative facets of the relations, such as taking the case to court in case of opportunistic partner activities, coordination provisions provide guidance on positive aspects instead – for instance, collective goals and the intended measures to achieve them (Klein Woolthuis et al., 2005). Provisions that can be assigned to the coordination function therefore deal with the description of responsibilities and tasks (e.g. Argyres et al., 2005; Dekker, 2004; Klein Woolthuis et al., 2005), reporting procedures (e.g. Argyres and Mayer, 2007; Reuer and Ariño, 2005), project schedules/milestones (e.g. Anderson and Dekker, 2005; Avadikyan et al., 2001; Ryall and Sampson, 2004) or designation of specific persons as project managers (e.g. Klein Woolthuis et al., 2005; Ryall and Sampson, 2004).

### 3.2.3 The Contingency adaptability function

Both the safeguarding and the coordination functions of inter-firm contracts deal with reaching the meeting of the minds at an early stage of the relationship, thus aligning the incentives and clarifying the responsibilities of both partners prior to the actual transaction (Eckhard and Mellewigt 2006). By doing so, partners strive towards the aim of managing all inherent relational and performance risks that are laid out already at the outset of the collaboration. Knowing that the following execution phase of the agreement takes place within a *per se* uncertain future, additional risks arising from this uncertainty cannot be foreseen and might challenge the balanced alignment of incentives and responsibilities achieved initially and codified through the contract. In order to handle these performance risks caused e.g. by technological or economic

developments (Carson, Madhok and Wu, 2005; Klein Woolthuis et al., 2005), transaction cost economics (TCE) suggests to integrate risk preventive terms into the contract to the extent possible. The argument is that uncertainty, which bears the potential of high *ex post* transaction costs, should be mitigated by deliberately incurring costs for adequate *ex ante* mechanisms, such as contractual provisions. Thus, contracts can serve a third function, namely *contingency adaptability*, which aims at specifying principles or guidelines how to handle unanticipated contingencies that might arise at a later stage of the collaboration (Luo, 2002; Mayer and Bercovitz, 2003). Unequivocally, this contractual function does not refer to unforeseen opportunism (Klein Woolthuis et al., 2005) but rather to changes of commercial contingencies in the transaction environment, such as fluctuations in demand, supply or technology (Gulati et al., 2005). Therefore, adaptation concerns stemming from a highly instable transaction environment can be considered the main driver for the incorporation of provisions aiming at contingency adaptability in inter-firm contracts. (Eckhard and Mellewigt 2006, 19)

Contingency adaptability can be addressed in contracts in the form of mutually agreed tolerance zones for dealing with unexpected events or as specific procedures and guidelines on how to handle changed circumstances or how to overcome conflicts. Provisions typical of this contractual function deal with *force majeure* (e.g. Klein Woolthuis et al., 2003; Luo, 2002), price adjustment (e.g. Carson et al., 2005; Crocker and Reynolds, 1993; Czaban, Hocevar, Jaklic and Whitley, 2003; Mayer and Bercovitz, 2003) or engineering change procedures (e.g. Argyres and Mayer 2005).

### 3.3 SUMMARY

To wrap up the discussion on contractual functions, Eckhard and Mellewigt (2006) consider the role of contracts as *safeguarding*, *coordination* and *contingency adaptability* devices to be empirically confirmed. All three functions deal with the management of special types of concerns in inter-firm relationships, stemming from determinants such as asset specificity, task interdependence or transaction instability that require distinct contractual provisions. These concerns coincide with different underlying positions or attitudes towards the partner; while appropriation concerns are stimulated by a rather adverse perspective towards the partner, the parties face coordination

concerns jointly, thus following a collaborative approach in order to solve the challenges posed by the task. Eckhard and Mellewigt (2006) also emphasize the effects that experience gained from prior relationships have on contracts. The impact of prior relationships diverges according to foundations of trust vs. learning-related theoretical models.

Somewhere in between, adaptation concerns arise out of commercial contingencies and make such provisions necessary which account for an either collaborative perspective, such as finding new sales opportunities in case of declining market demand, or an adverse attitude, such as solving a conflict on how to share increasing input prices, e.g. for raw materials (Carson et al., 2005; Luo, 2002; Mayer and Bercovitz, 2003). New contract models, such as the agile contract, are trying to formalize these concerns.

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## 4 APPLICATIONS: PROACTIVE CONTRACTING IN VALUE CHAIN MANAGEMENT

*Kaisa Sorsa*

After discussing the legal framework of business, we re-examine Figure 2 (on page “189”) and look at the other elements of the business environment. One of them is the line of business or industry in which a company operates and has its core competences. This context is of particular importance and has an overall impact on the capabilities needed in the company. The corners of the triangle represent components within an organization that are intertwined and in close interaction with each other. When well-managed, they support the company’s business. The following components are an integral and necessary part of corporate contracting capabilities: *the strategy component* which incorporates strategies and policies formulated at the top level of the organization (e.g. competition strategy or CSR strategy), *the operational component* which encompasses contract and business processes<sup>81</sup> and finally the knowledge generating and information providing component. This component serves contracting by providing the necessary information needed in all of the company’s transactions and operations, and in optimal cases helps generate knowledge for the company to utilize in its future strategies and operations. (Salmi-Tolonen 2008, 2–3).

*An overview of the effects of CSR on six different determinants of competitiveness at the firm level – cost structure, human resources, customer perspective, innovation, risk and reputation management, and financial performance – shows that it can have a positive impact on competitiveness. The strongest evidence of a positive impact of the CSR on competitiveness appears to be in areas of human resources, risk and reputation management and innovation. The reputation of a company in terms of CSR becomes increasingly important in the potential to be successful in recruiting staff on highly competitive labour markets. (European Competitiveness Report 2008, 12).*

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81 E.g. what does the defined competition strategy or CSR strategy mean from contracting perspective.

Contracting always takes place in a certain context. An understanding of the general and business environment (domestic/international; industry sector) in which the contracts and projects must be executed is essential for the management of resources and capabilities needed in that context. *The general environment* includes the demographic, the economic, the political/legal, the socio-cultural, and the technological segments. The task specific environment includes the industry sector and value chain context as well as the specialties of an organization (Sorsa 2011a, 44–62).

Based on the vast research literature for and against the topic of Corporate Social Responsibility one can confirm that CSR issues run through every business sector as well as the public sector<sup>82</sup>. The role of business has shifted from profit maximization for shareholders within the obligations of law to responsibility to a broader range of stakeholders, including communal concerns such as protection of the environment, social and economic responsibility and accountability on ethical as well as legal obligations. These broader concerns are not necessarily seen to conflict with shareholder interests but to protect their interests in the long run. CSR is not philanthropy, contributing gifts from profits, but involves the exercise of social responsibility in how profits are made (Porter and Kramer 2011; Sorsa 2011a, 57–60).

#### 4.1 BUSINESS ENVIRONMENT AND VALUE CHAIN MANAGEMENT

The business environment can be analysed using the Global Value Chain approach<sup>83</sup>. The GVC is widely adopted by researchers, industry, and development practitioners to understand the political economy of

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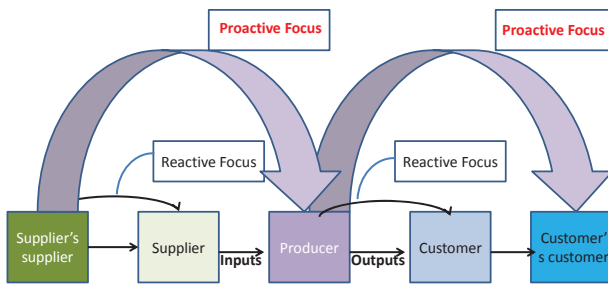
82 The most important public sector recommendations have been updated in 2011. E.g. OECD Guidelines for the Multinational Enterprises, recommendations addressed by governments to multinational enterprises operating in or from adhering countries, provide non-binding principles and standards for responsible business conduct in a global context consistent with applicable laws and internationally recognised standards. Changes include a new human rights chapter, a new and comprehensive approach to due diligence and responsible supply chain management, a pro-active implementation agenda to assist enterprises in meeting their responsibilities as new challenges arise.

83 In the vocabulary of the business people the value chain is used to express the core idea of business. Value chain can be defined as the full range of activities (primary and supportive activities) that are required to bring a product from its conception to its end use. These include design, production, marketing, distribution, and support to deliver the product to the final user. Value chains are one of the most important elements of the networks or production systems. The activities that comprise a value chain may be contained within a single firm or may embrace many firms, NGOs and civil society organizations. They can be limited to a single country or stretch across national boundaries (Altenburg 2007, 6).



contemporary global production systems. More recently it has been used as a tool to analyse different aspects of chain coordination and governance (Gereffi, Humphrey and Sturgeon, 2005).

Why is the value chain so important? By understanding the extended supply chain we increase our overall understanding of **value**, which in turn leads to proactive measures and preventive action. A supply chain is a series of links. When we focus on the link in front of us then we can – at best – only take a reactive approach to problem solving. But, if we focus on the links further down the chain, we can **increase our reaction time** and become proactive. Thus, to help your supplier respond to your needs better, you need to include your supplier's supplier into the chain and introduce your customer to your supplier.



**FIGURE 4.** *From contractual relationships to extended relationships.*

Supply chains are made of weak ties and break easily when a new supplier joins the chain. Value chains are made of strong ties and are harder to break. Price alone is insufficient to break the value chain. Every supplier is an investment in time and money to build the relationship and to strive for continuous process improvement.

#### 4.1.1 Different kinds of value chains

Value chain coordination and governance<sup>84</sup> is primarily based on a) contracting, b) private regulation (the role of standards, code of ethics etc. in contracting) and c) in relational issues in different parts of the value chain. Market power plays a pivotal role affecting the way rules are set, implemented and monitored. The contract's role in the value chain management is crucial.

In order to understand the role of contracting in value chain governance, one needs to take into account the ability of the lead firms located in distant locations to define production and trade conditions (expressed in contract terms and standards) in developing countries (Sorsa 2011a). Contracts for exchanges within the value chain (and in particular terms concerning quality and safety) are meant to complement state and international public regulation, but also to ensure enforceability of the international soft laws (Sorsa 2011a).

With the concept of value chain governance as a central concern, it becomes necessary to follow the actors along a chain to assess the constraints on behavior and incentive structures affecting companies' business strategies.

##### Example

International coffee roasters are essentially driving governance along global coffee chains (supplier driven value chain). Large branded roasting companies are at the forefront of dictating governance structures, coordinating modes of operation for international trading companies, producing-country governments, and producers as well as, in many cases, retailers and consumers.

McDonald's in fast food service sector is driving governance along several global value chains (chicken, beef etc.) (buyer-driven value chain)<sup>85</sup>.

Understanding the role of a single company in the global or national value chain helps understand why the contract terms and contract processes are what they are and why they should be adjusted to better follow the principles of shared value in the value chain instead of short-term value for the individual organization (Porter and Kramer 2011). "Attempts by corporations to establish

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84 Humphrey and Schmitz (2004) define "governance" as the process of specifying, communicating, and enforcing compliance with key product and process parameters along the value chain. This definition emphasizes the ways in which leading firms, often multinational companies, set the parameters within which other actors elsewhere in the chain must operate.

85 See McDonald's Case [http://www.aboutmcdonalds.com/mcd/csr/report/sustainable\\_supply\\_chain.html](http://www.aboutmcdonalds.com/mcd/csr/report/sustainable_supply_chain.html)

rule-based constraints on behavior without the direct coercive intervention of states or other external actors” (Graham and Woods (2006, 869) are manifested in CSR standards or product standards. Value chain governance, then, is evident within the various CSR initiatives.

According to different researchers, the value chains can be described to be either producer-driven, retail-driven or modular (Gereffi and Memedovic 2003).

In the buyer-driven value chains, large buyers with core competences in branding and marketing are the driving actors in setting up these value chains. They increasingly organize, coordinate and control the production, designing and marketing activities to target consumer markets in developed and developing countries, and in the transition economies. These chains are typical for labour-intensive industries and are highly relevant to the developing countries (for instance, agro-food industries, textiles, garments, footwear, toys, furniture etc.). The producers of branded products, e.g. Nestle in food value chain, are keen to maintain the value of the brand and to avert copying through protecting intellectual property. Their strong market position is the result of the global brands and brands for a specific market or region. (Memedovic 2004, 12)

#### Example

The apparel industry is identified as *a buyer-driven value chain* that contains three types of lead firms: retailers, marketers and branded manufacturers. With the globalization of apparel production, competition between the leading firms in the industry has intensified as each type of lead firm has developed extensive global sourcing capabilities. While “de-verticalizing” out of production, these firms are fortifying their activities in the high value-added design and marketing segments of the apparel chain, leading to a blurring of the boundaries between them and a realignment of interests within the chain. (Gereffi and Memedovic 2003)

In the producer-driven value chains, key producers in the chain control vital technologies, which are of crucial importance for positioning in the final product market. They coordinate these value chains and take responsibility for helping the efficiency efforts of their suppliers and their customers. These chains are typical for medium and high-tech industries, such as automobiles, electronics, telecommunications, and the like. (Memedovic 2004, 12)

Currently, producers and processors in many sectors face a monopsony<sup>86</sup> situation in which their customers – the supermarket chains and food service companies – have a tremendous market power. These big supermarket chains economize and lower their own costs by extracting more favourable terms from their suppliers: either through demanding lower merchandise prices or greater provision of services, such as special packaging or third-party food safety certification, or demanding payments of fees. Savings are also achieved through paying careful attention to managing and evaluating shelf space, and to distribution logistics.

Distribution is considered as important as retailing in driving costs out of the system. Savings can be made firstly by eliminating the role of the traditional wholesaler through direct supply from primary producers and manufacturers to regional distribution centres (RDCs), and then on to superstores, and recently by taking over parts of the upstream distribution network from suppliers where savings are perceived. As food retailing has very high labour costs relative to profits, there has also been much attention to managing labour costs and increasing labour productivity.

#### 4.1.2 Value chain analysis from the company perspective

At the company level the value chain analysis has become a crucial strategic tool for gaining competitive advantage. Value chain management (VCM) ties together different activities, from planning to development, buying, producing and selling connecting them into integrated inter-company relationships that enable companies to target big markets and get considerable benefits<sup>87</sup>. Since international trade is increasingly taking place between formally independent companies in networks, rather than through arm's-length transactions or intra-firm trade, and since the lead firms in GVCs (global value chains) are key actors in managing these global production systems and global trade, they can influence the contractual issues and innovation prospects of the participating firms. The lead firms in GVC range from those Transnational Companies (TNCs) who are producers, but procure raw materials and other inputs from suppliers around the globe, to those who are retailers and branded marketers

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86 Monopsony is the buying equivalent of monopoly, where the product or service of several sellers is sought by only one buyer.

87 See e.g. IKEA's IWAY standards for procurement and IKEA's marketing activities promoting sustainable products.

of manufacturers and do not produce goods, but play a key role in organizing production at different locations scattered around the world.

This management tool helps better understand the need for synchronized products, information, processes and cash flow within the value chain. Central to this business strategy is to create trust-based relationships, between and in different links in the chain, and between producers, and immediate customers and suppliers (Memedovic 2004, 8).

The different business strategies which companies are using depending on the value chain model in CSR driven business environment are (Koehler 2011):

- *Growth play*: Company can aim at capturing new markets or sustain existing markets.
- *Competitive play*: Company uses peer-to-peer or differentiation from competitors.
- *Brand play*: Re-enforcing strategy in which company tries to adjust how stakeholders think of the company brand and/or product brand.

*Research shows that companies pursue eco-labels for a variety of reasons. Most notably, the decision does not appear to be driven by consumer demand as much as by the changing B2B landscape. More companies are responding to customer demands for a sustainable supply chain. Some companies use eco-labels to maintain their hold on markets where mandated purchasing requirements are shifting demand to sustainable products. Other companies use eco-labels to promote global brands or to rally consumers behind public commitments to corporate sustainability goals. For each company, an eco-label strategy depends on the business model, product portfolio, sustainability mission and brand. Execution also depends on a variety of market conditions, including different national consumer preferences and the characteristics of individual supply chains. (Deloitte 2011, Eco-labels)*

Which one of these strategies are used depends on the company's position in the value chain and its overall assessment from a company's vision and its capabilities. Many small and medium size companies face several challenges set by the business environment and the potential customers:

- more and more demanding markets
- increasing number of standards and requirements set by contractors

- lack of understanding of the upgrading challenge in the particular GVC in which they participate: GVC characteristics (structure, governance, geography)
- lack of awareness of their competitive strength
- Insufficient access to information, tools and training; limited managerial skills and financial resources
- inadequate support for technological innovation and learning
- lack of direct contacts with customers: How to avoid captivity in GVCs? How to protect their IPRs?

## 4.2 OPPORTUNITY MANAGEMENT PERSPECTIVE

How do companies use the different legal and non-legal tools (contracts, standards, relational methods) for managing the challenges set by the business environment, guided by their risk-averseness? The environmental uncertainty that surrounds entrepreneurial actions includes both opportunities and threats. In common practice, risk management tools only address threats. While this approach is surely better than doing nothing, it can still be seen as a major weakness of the traditional Risk Management approach. (Junge 2009, 10)

### 4.2.1 Opportunity management

Opportunity Management is a counterpart to all Risk Management systems. It supports strategic decisions, it can increase productivity and it can improve the financial transparency of companies. Apart from the financial side, a systematic tracking and management of opportunities can create new chances in other areas or projects. Junge (2009) proposes a strategic opportunity management process closely linked but detached from the existing risk management process in order to identify and manage opportunities.

This chapter aims at giving ideas to managers or future managers who strive to improve the professionalism of their companies in terms of strategic thinking and proactive contracting as a value chain management tool. If not used proactively, contracts sometimes block opportunities for innovation (Henschel 2009). As a result, efforts are invested in continually fighting fires, rather than

developing longer term strategies that could lessen risks and/or their severity (Gooch et al. 2009). In proactive contracting, contracts should primarily be used to manage opportunities as well as risks.

The term ‘risk’ is used by risk practitioners to embrace the possibility of both negative and positive consequences despite the dictionary definition. According to the ISO standard, the term ‘risk’ is understood as the combination of the probability of an [unwanted] event and its consequences (ISO Risk management 2002, definition 3.1.1.). Risk management is understood by ISO as a set of co-ordinated activities to direct and control an organization with regard to risk. (ISO 2002, definition. 3.1.7) The latest view is that ‘risk’ in a negative sense should be referred to as threat whereas ‘risk’ in a positive sense should be called opportunity (Junge 2009, 9).

The notion ‘Opportunity’ is defined by Junge (2009) for all chances that are ripe for decision and that will occur if one decides to utilize them. Furthermore, the term applies to all positive deviations from objectives that arise from topics that are already part of corporate planning. The colloquial definition of opportunities, or “having good prospects”, supports this proposal (Junge 2009, 13). For the purposes of this section opportunity is specifically used to define those unplanned and uncertain events with the possibility of positive consequences.

*The tactical, bottom-up approaches to analysing numerous risk statements have, in today’s complex, distributed programs and environments led to partial views of the “big picture” and inefficient allocation of scarce resources. Many risk management processes have turned into time and resource-intensive bureaucratic nightmares that, in the end, not provide the right information. The SEI recognized that something else clearly needed to return risk management to its original purpose—supporting effective management decisions that lead to program success. Current SEI research is focused on systemic risk management – top-down, system-oriented analyses of risk in relation to program objectives – which is better suited to managing risk in distributed environments. (Dorofee 2009)*

Opportunity Management is the technique by which companies can identify and understand possible improvements to their business objectives. As with risk definitions an opportunity is characterized by its lack of certainty, in other words, if an improvement is certain to be achieved then it is no longer an opportunity. The term ‘probability’ is again used to describe the likelihood of occurrence (Junge 2009, 13; Dorofee 2009).

The mission of Opportunity Management is to improve the standard of knowledge about arising chances, to track the right chances, to utilize the right opportunities and, as a prerequisite, to create the necessary Opportunity Management framework. In addition to these active elements, Opportunity Management has the aim of improving opportunity awareness in the company (Junge 2009, 12).

The process for managing opportunities is very similar to that defined for managing risks. The same four-stage iterative process – Identify, Analyze, Plan and Manage – should be deployed with a documented plan of who does what, when and how. This is usually combined with risk management in a Risk and Opportunity Management Plan.

#### 4.2.2 Opportunity management in the value chain

Managing a value chain is different from managing an individual organization. Well-run enterprises acknowledge that operating as a part of a closely-aligned value chain can limit their exposure to risks that result from retaining a trading mind set. The creation and management of formal value chain initiatives vary in different industry sectors. It is a relatively new development, for instance, in the agriculture and agri-food industry in Canada (Gooch et al. 2009), but it is quite a developed method in such industries as technology and automotive industries in general and, for instance, in agri-food industry in Finland (Sorsa 2009d, 100–114).

The minimum regulations to which a pig farm or other actors within pork value chains must conform to are imposed by the national and EU legislation. This is rarely seen to be sufficient and Sikava, the Finnish health classification system for piggeries, has created a brief set of regulations that are called the requirements for responsible production of pork. The organization has drafted regulations for the national level of health monitoring, which consists of the very basics of animal health, and the special level of health monitoring, which consists of stricter regulations. The regulations of Sikava are often referred to by the companies in the business. Sikava is run by the Finnish Association for Animal Disease Prevention. These regulations are often referred to by the sourcing and refinery companies in order to explain their expectations of the quality and food safety level. Belonging to Sikava is voluntary but in practice all Finnish pig farms have joined it, as it is imbedded into the system and seen the proper thing to do.

Gooch, Felfer and LaPlain (2009) have developed a framework to help businesses identify potential risks associated with forming and managing a



value chain, to assess the impact that a specific risk could have on a value chain initiative, and mitigate the risks faced by executing contingency plans with precision, by motivating individuals to monitor and manage risks to the best of their ability (Gooch et al. 2009).

Because companies are often parts of a global value chain, a holistic approach to opportunity management needs to be applied. Therefore, all key stakeholders in all “opportunity areas” have to be taken into consideration. This can be accomplished by closely leaning the Opportunity Management approach against Porter’s concept of the value chain. According to Porter, every company has an individual value chain. This chain is embedded in a system of up and downstream value added chains of suppliers and customers.

Porter (1985) defines a value chain as follows: “Value activities are physiologically and technologically differentiable activities of a company. They are the building blocks that the company uses to build a valuable product for its customers. The margin is the difference of the aggregate value and the sum of all cost that arises through the conduction of the value activities.” Porter’s original value chain concept is criticized by experts for solely focusing on internal processes. They argue that the concept neglects environmental influences which are necessary in order to generate a pristine picture of the competitive situation of a company.

Opportunity Management ultimately aims at utilizing additional business opportunities. These new opportunities are mostly congruent to the cost and differentiation advantages that are subject to Porter’s concept of the value chain (Junge 2009, 19). Environment strategic area was added to the model by Junge (2009, 20) in order to take into account the broad group of stakeholders. Examples for stakeholders in this area would be customers, competitors, shareholders, trade associations, standardization organizations etc.

## 4.3 CONTRACTUAL RELATIONSHIPS AND VALUE CHAIN MANAGEMENT

### 4.3.1 Long-term vertical co-operation

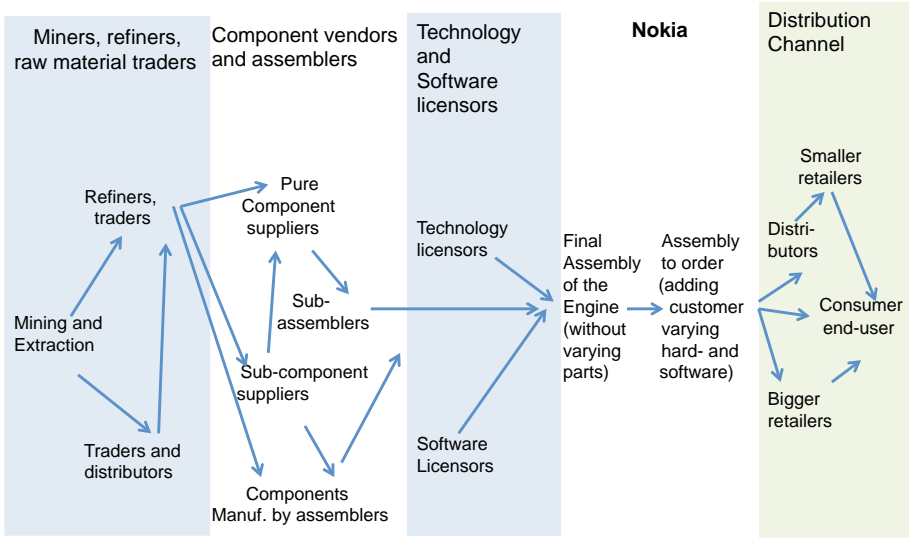
Modern value chains are characterized by high levels of private sector governance by proactive contracting and long-term vertical coordination. This phenomenon can be seen both in product-related value chains as well as in

service value chains. Private standards and associated certification and labeling schemes are an inevitable part of today's business and proactive contracting. They have emerged as key tools for managing quality, food safety and various intangible attributes relating to production practices within the supply chains of multiple food retailers and branded manufacturers and processors. Prime example is Global Good Agricultural Practices protocols which are used over in 100 countries all over the world. (Sorsa 2011a; Koehler 2011)

The modern supermarket model is one example of buyer-driven value chains. Buyer-driven value chains are characterized by high levels of *private sector governance* and *long-term vertical coordination e.g. agri-food chains with associative (rather than arms-length) supply relationships using preferred suppliers*. Supply chain management (i.e. achieving the right mix of products for maximum profit and minimum waste) is being outsourced to produce suppliers. While the retailer sets the 'rules of the game' for participating in the chains, a key supplier may take responsibility for developing a product category's profile to give maximum returns, such as by devising new packing strategies, or taking more responsibility for unsold produce. Supermarkets are the major force in the 'private re-regulation' of agriculture and the transition to 'buyer-driven' chains. (Memedovic 2004)

*Traceability-driven* CSR initiatives (UTZ Certified, FairTrade, FSC, etc.) have clearly emerged as an important tool with which leading firms implement value chain governance. (Neilson 2008, 1610)

*Long-term vertical coordination* takes place between producers, supplier-integrators, processors and retailers. This element highlights the relational aspects of the partnerships in the value chain management. Production contracts and supply chain management are the key tangible tools in buyer-driven value chains, which allow a company to influence production, reduce procurement costs and price risks as well as maintain flexibility, while avoiding the risks and capital outlay associated with the operations.



**FIGURE 5.** Long-term vertical coordination in Nokia N95 supply chain (Ali-Yrkkö et al. 2011, 266).

Organizations tend to seek partners for the value chains in which they operate that share, for instance, common environmental goals. Proactive organizations, then, typically include into their source selection processes criteria, such as procurement codes of conduct, that favour proactive suppliers.

### Example

In Huhtamäki's (a Finnish stock exchange quoted corporation) General Terms and Conditions of Purchasing Huhtamäki requires "The Supplier to ensure that the Huhtamäki Code of Conduct for Huhtamäki Supplier (see. [www.huhtamaki.com](http://www.huhtamaki.com)) is applied. The Supplier shall ensure that the products have not been exposed to any microbiological, foreign body or chemical hazards, and the Supplier shall provide the Buyer with all information of the characteristics of the Products on request. Documentation evidencing the compliance with the above and all necessary information of quality, environmental, health and safety effects of the Supplier must be made available by the Supplier on request" (Article 6).

Proactive organizations also make an effort to improve the performance of the partners they choose by providing training and technical assistance, sharing databases, and working together to develop new tools, processes, and practices.

Such cooperation is not altruistic and can often involve hard bargaining and negotiation over how to share the gains of the cooperation. By helping integrate the value chain, such activities reduce each participant's costs of achieving any given environmental goal for the internal processes it uses and the products that it offers. (Camm and Drezner and Lachman and Resetar 2001, 18–19; Roome 2004)

In order to understand the role and usability of different standards<sup>88</sup> and certification for a company's business, one needs to be aware of who has set the standards (Figure 3). One way to categorize standard setting and monitoring is to use terms *top-down* and *bottom-up*. Another way is to make a distinction between *single company standards* and *standards set by different coalitions and networking actors*.

In software development, competence leaders work with people to discuss their own internal standards, not management-imposed standards, such as naming conventions, coding standards, user interaction conventions, file structures, configuration management practices, tools, error log standards, and security standards (Poppendieck 2007, 193). There is no need for the management to implement top-down standardization. Bottom-up standardization will occur when goals and metrics make it painfully clear to the employees that it is more optimal for them to change. (Appelo 2011, 246)

If standards are set by e.g. retail organizations only, their credibility is not as good as when they are set by a multi-stakeholder coalition. This is important in order to make the strategic decisions which value chains and which markets (B2B; B2C or B2G and which geographical markets) a company would like to use as a distribution channel. However, in all cases these decisions are only one part of the decision making, as 'voluntary' standards often act as entrance tickets into the market – producers must comply with the standards, and be able to demonstrate that they have done so, or their products will not reach the supermarket shelves. Even if compliance with private sector standards is not required by law, private companies often set it as a precondition of business in practice. Even if not officially required, a certified supplier is always favoured compared to a non-certified supplier (Exporting to Finland 2008).

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88 Stakeholders want to know every detail of companies' behaviour in different situations and put a lot of pressure on legislators to produce more rules and regulations to control companies. Media are active and keep these issues in the spotlight, especially if they find non-compliance with the rules or other unethical behaviour. Additionally, for example consumers pay more and more attention to the conditions in the supply chain, especially to the effects of production on environment and labour.

## Example

Especially in the food sector, product safety is an extremely important issue throughout the value chain. The Hazard Analysis and Critical Control Point (HACCP) system is in many cases a legal requirement but, due to the increasing market pressure, it is applied also voluntarily. In Finland, two retail chain companies which cover almost 85 per cent market share of the Finnish retail business require the importers to have e.g. GLOBALGAP, BRC, IFS or other international food safety standards in order to get into Finland's retail value chains. In many cases, buyers use standards as part of their basic requirements to the suppliers.

Different business environments and business sectors have different business ethics. The differences can be seen e.g. in the way the industry self-regulates its activities (Sorsa 2009d). Self-regulation relates to the contracting when it produces tools to manage contractual issues e.g. by creating General Terms and Conditions for the industry or by drafting codes of conduct.

### 4.3.2 How private regulation and contracting co-operate

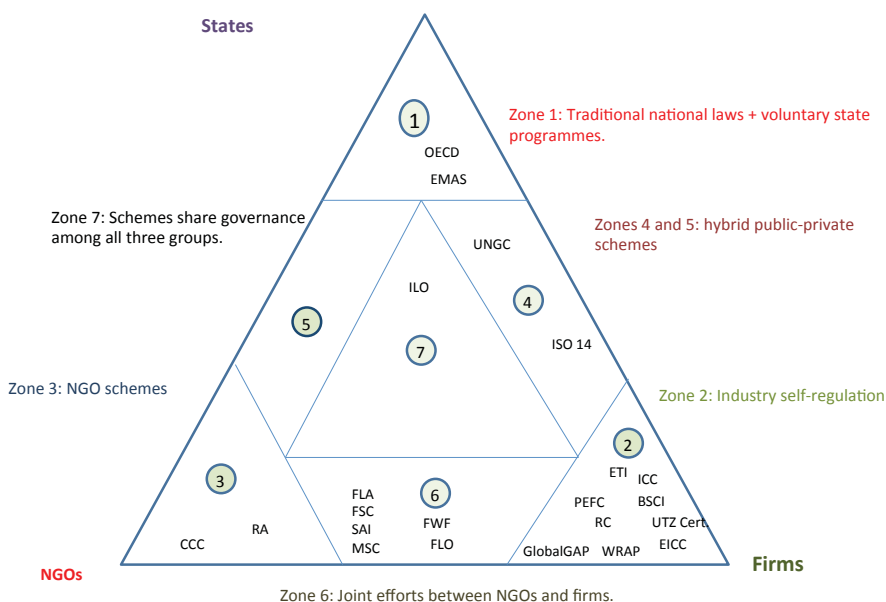
Abbot and Snidal (2009, 507) have designed a Governance Triangle (GT) to demonstrate the different roles of the actors in the making of private regulation schemes in the global value chain management. The GT depicts the multiplicity and diversity of private regulation schemes in terms of participation by three main actor groups: States, Firms and NGOs (non-governmental organizations). The GT model is borrowed from Abbott and Snidal and used here (Figure 6) in order to present the diverse almost twenty schemes which were included in the research conducted by Sorsa (2009d; and 2010c).

The schemes shown on the triangle are identified in Table 1, with the dates of their first significant regulatory standard-setting activities. The points on the triangle locate individual mostly private regulation schemes according to their most salient and innovative feature: the relative “shares” that Firms, NGOs, and States exercise in scheme governance<sup>89</sup>. These three actor groups – the potential participants in regulatory governance – also define the Triangle as a whole; its surface thus represents the potential – regulatory space<sup>90</sup>. (Sorsa 2010b, 84–9)

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89 See also Cafaggi 2010, 18–20.

90 Christine Parker's metaphor about the regulatory space highlights the importance of other systems of rules with which the legal rules must always compete against. (Parker 2003, 391)



**FIGURE 6.** Comparison of different private regulation schemes using governance triangle. (Abbott and Snidal; Sorsa 2010d, 5).

The reasons why companies cooperate by constraining themselves were analyzed using 42 private regulation schemes as a research object<sup>91</sup>. Understanding how, why, when and under which conditions trade associations and other networks see self-regulation or private regulation relevant and reasonable to them provides insights into the role of private regulation and legislation in business contracting. The explanations have so far applied both the theory of new institutional economics and the transaction cost theory, but less the theories known in the field of strategic management.

91 These self-regulation schemes are discussed more deeply in Sorsa 2009d, 2010b and in 2011a.

**TABLE 1.** *List of private regulation schemes used (Sorsa 2010d, 5).*

Zone 1	<ul style="list-style-type: none"> <li>• <b>OECD</b> OECD Guidelines for Multinational Enterprises 1976</li> <li>• <b>EMAS</b> EU Eco-Management and Audit Scheme 2009</li> </ul>
Zone 2	<ul style="list-style-type: none"> <li>• <b>ETI</b> Ethical Trading Initiative 1994</li> <li>• <b>ICC</b> Int'l Chamber of Commerce Charter for Sustainable Development 1991</li> <li>• <b>BSCI</b> Business Social Compliance Initiative 2003</li> <li>• <b>UTZ CERTIFIED 1997</b></li> <li>• <b>EICC</b> The Electronic Industry Code of Conduct 2004</li> <li>• <b>RC</b> Responsible Care, chemical industry environmental scheme 1987</li> <li>• <b>GLOBALG.A.P</b> Global Good Agricultural Practices 1997</li> <li>• <b>WRAP</b> Worldwide Responsible Apparel Production, industry labor code 2000</li> <li>• <b>PEFC</b> Programme for the Endorsement of Forest Certification 1999</li> </ul>
Zone 3	<ul style="list-style-type: none"> <li>• <b>CCC</b> Clean Clothes Campaign Code of Labor Practices for apparel 1998</li> <li>• <b>RA</b> Rainforest Alliance 1989</li> </ul>
Zone 4	<ul style="list-style-type: none"> <li>• <b>ISO14</b> International Organization for Standardization 14001 environmental management standard 1996</li> <li>• <b>UNGC</b> United Nations Global Compact 2000</li> </ul>
Zone 5 – Zone 6	<ul style="list-style-type: none"> <li>• <b>FLA</b> Fair Labor Association; apparel industry scheme 1999</li> <li>• <b>FSC</b> Forest Stewardship Council certification, labeling scheme 1993</li> <li>• <b>SAI</b> Social Accountability Int'l standard for supplier labor practices 1997</li> <li>• <b>MSC</b> Marine Stewardship Council 1997</li> <li>• <b>FWF</b> Fair Wear Foundation 1999</li> <li>• <b>FLO</b> Fairtrade Labeling Organization – fair trade “umbrella scheme” 1997</li> </ul>
Zone 7	<ul style="list-style-type: none"> <li>• <b>ILO</b> International Labor Org. Declaration on Multinational Enterprises 1977</li> </ul>

### 4.3.3 B2B relationships

In global competition, good quality products are seen as the minimum requirements, but they do not alone generate any more competitive advantage to the company. Therefore companies do not succeed in the competition any better only by improving their own business processes (e.g. using ISO 9000 or ISO 14 000 standards which focus on the development of the company's own processes). This means transformation to improve the processes which link companies with other companies (Sorsa 2011a, 88–89).

The contact points between different companies are governed by contracts and by personal relationships, but horizontal or network relationships are governed by self and private regulation. In these broader networking relationships quality standards, CSR standards and tools to manage efficiency in the value chains are important. (Sorsa 2011a, 91).

In order to give retailers and consumers assurance of product safety and certain aspects of production methods, “food assurance schemes” at the farm level (pre-farm gate process standards), and sometimes covering the whole food supply chain (post-farm gate), were developed. The most prominent example in this category is the GLOBALGAP (formerly EurepGAP). According to the Agri 238 report, these schemes do not always add any particular characteristic to the product or its production method but assure that all legal requirements have been complied with (Agri 238, 6). This may be true in Europe, but when the requirements of GLOBALGAP are applied in the farms or packaging processes in the developing countries, the situation is totally different. Compared to the developing countries legislation, these requirements go far beyond the requirements of the local legislation. (Sorsa 2011a). Other food safety requirements are required for the processing and distribution phases of the value chain.

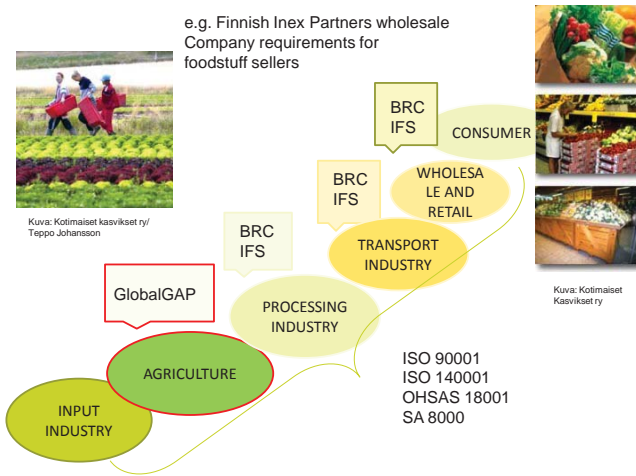
The methods and tools of self and private regulation vary depending on the value chain model – buyer-driven, producer-driven or modular and industry sector. Also, differences between the self-regulation methods are dependent on the relationship type – short term or long-term relationship. In business to business (B2B) relationships mainly different product or process standards (ISO 9000, ISO 22 000) and codes of conduct (ETI<sup>92</sup>) are used in order to

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92 The Ethical Trading Initiative (ETI) is a *multi-stakeholder initiative* (brand companies, NGOs, trade unions). The initiative started in the late 1990s, when companies selling food and clothing to the UK consumers were under an increasing pressure to ensure decent working conditions for the people who produce the goods they sell. The ETI was set up in 1998 to bring the combined knowledge and influence of the relevant NGOs and the international trade union movement to work side by side (van Yperen 2006, 31). According to Moilala (2006, 20-21), when companies import products from outside the EU, the assurance of the product quality comes more and more important to them.



guarantee the quality, product safety, environmental aspects, ethical or social aspects (ISO 14000, SA8000, BSCI<sup>93</sup>, OHSAS 18000) of the production to the buyer (Figure 7). Also cost efficiency is mentioned as a reason to use self-regulation (e.g. BSCI, UTZ Certified) as a governance tool in B2B relationships. In these schemes, the approach to self-regulate seems to be the preventive minimization of the risks (Sorsa 2009d, 128). All these standards and codes of conduct are in use in buyer-driven value chains.



**FIGURE 7.** *Whole Sale Company requirements for Foodstuff sellers.*

Many self-regulation systems use the ethical issues as a source of differentiation and aim to distinguish certified products from others by highlighting certain product or process attributes (e.g., observance of strict environmental requirements, social standards, animal welfare, organic farming, origin etc.) (Sorsa 2009d, 58–65). Trade associations encourage their member companies to use the codes in their contractual relationships (see example below in Figure 8).

93 The Business Social Compliance Initiative (BSCI) is an industry-led platform, an initiative of the European retail companies initiated by the Brussels based Foreign Trade Association (FTA). In 2002, a common platform was established for the various different European Codes of Conduct and monitoring systems and to lay the groundwork for a common European monitoring system for social compliance. In 2002 and 2003, retail companies and associations held several workshops to determine the framework for such a system. In March 2003, the FTA formally founded the Business Social Compliance Initiative (BSCI). Audited suppliers are registered in the BSCI Database so that there is no need for other BSCI members to audit the same supplier. This decreases the costs for the supplier and enhances the efficiency of the improvement process.



Global Social and Environmental Responsibility  
Operations Supply Chain Social and  
Environmental Responsibility  
June 1, 2009

**ELECTRONIC INDUSTRY CODE OF CONDUCT (Version 3.01 – 1 June 2009)**

"To adopt the Code and become a participant ("Participant"), a business shall declare its support for the Code and actively pursue conformance to the Code and its standards in accordance with a management system as set forth in the Code.

For the Code to be successful, Participants must regard the code as a total supply chain initiative. At a minimum, participants shall also require its next tier suppliers to acknowledge and implement the Code."

**FIGURE 8.** *Electronic industry code and contractual relationships.*

Mere encouragement is not enough, however, if no sanctions for contraventions can be imposed. For instance, Intel's reaction to wrongdoing is the termination of the supplier agreements and banning future contracts. Consequences reach even the suppliers' employees (Figure 9). Companies that take ethical issues seriously try to help their personnel and suppliers to understand and implement their codes of conduct into their business culture.<sup>94</sup>

## Consequences of Wrongdoing

- Violation of the Code of Conduct or Intel's ethical expectations results in disciplinary action
  - Intel employees: up to and including termination of employment
  - Suppliers: up to and including termination of supplier agreements with Intel and banning future contracts with that supplier
  - Supplier employees (including contingent workers at Intel): denial of access to Intel or removal from Intel's premises
- Intel may seek restitution and legal action (where appropriate)



**FIGURE 9.** *Intel's disciplinary actions in case of wrongdoing.*

94 See Intel's Supplier Ethic's Training materials at <https://supplier.intel.com/static/ethics/voiceover/index.htm>

In a differentiation case, it is crucial that the traceability of the product can be guaranteed. The UTZ Certified, for example, uses the traceability issue as a decisive element and it is highlighted on their internet pages. For the differentiation purposes the contents of the supply contracts are crucial, as is the quality criteria used in procurement contracts.

The UTZ Certified highlights all dimensions of corporate social responsibility (ecological, social and economic) as well as the traceability. It is a market-oriented sustainability programme which is open to farms of all sizes. The Rainforest Alliance focuses more on the bio-diversity and social aspects. It awards certification to farms that meet a set of standards developed by the Sustainable Agriculture Network (SAN), a coalition of conservation and sustainable development NGOs with origins in Latin America. Fair Trade focuses mainly on social and economic dimensions. It aims at fair access to markets with a focus on sustainable production and improved living conditions for small scale producers or farmers.

Company success stories: The seventh edition of the Swiss Ethics Award Migros was one of the three companies awarded. Prizes were given to companies or organizations which have provided a special achievement in the field of ethics, social engagements, or sustainable development.

In 2005, Migros decided to source for 90% of its entire coffee assortment UTZ Certified coffee. This project clearly supports sustainable development, thus allowing to improve the use of natural resources (water, soil), and trace the product back to its origin. Moreover, this measure had a positive impact on the living and working conditions of coffee producers. Migros is also planning to use other certified products, such as cocoa.

The Swiss Ethics Award Was launched in 2005 by the University of Applied Sciences in Waadt. With this award concrete and original projects in the field of ethics and sustainable development are recognized and honoured, and therefore it serves to stimulate other companies. <http://www.utzcertified.org/en/newsroom/utz-in-the-news/2381-migros-ethics-award>

Public authorities can use self and private regulation systems in their procurement processes and contracts (tendering, bidding process, contract award and implementation) in order to enhance the number of sustainably produced products in public sector consumption (Figure 10).

**Inclusion of green and sustainable criteria in the EU public procurement:**

“Contracting authorities that wish to define environmental requirements for the technical specifications of a given contract may lay down the environmental characteristics, such as a given production method, and/or specific environmental effects of product groups or services.”

If a contracting authority intends to purchase Fair Trade goods, it can define in the technical specifications of the goods the relevant sustainable criteria, that must be linked to the subject matter of the contract and comply with the other relevant EU public procurement rules, including the basic principles of equal treatment and transparency. These criteria must relate to the characteristics or performance of the products (e.g. glasses made out of recycled material) or the production process of the products (e.g. organically grown).

Contracting authorities must always allow bidders to prove compliance with these standards by using Fair Trade labels or by other means of proof.

Environmental and social criteria may also be incorporated in the execution clauses, provided these criteria are linked to the execution of the contract in question (e.g. minimum salary for the workers involved in the performance of the contract) and comply mutatis mutandis with the other requirements mentioned above in relation to the technical specifications.

**Source: Fair Trade Public Procurement legal framework in the EU and the Member States. EFTA 2007.**

**FIGURE 10.** *Green criteria in public procurement processes.*

Until recently, companies have mainly used traceability for supply chain optimization. It has been a way to reduce costs or manage risks, to speed up delivery or trace bad shipments. However, we now see a shift where sustainability is becoming a driving force for supply chain traceability. Issues, such as global warming, water footprint, impact on natural resources and food security have become important issues in today’s corporate reality. Traceability can be used to make supply chains more transparent, to identify possible weak spots and to work on further improvements. In order to determine whether producers are farming sustainably, a clear standard needs to be in place.<sup>95</sup>

Product differentiation is used in all different value chains. Examples of different certification schemes range from company driven to NGO-driven self and private regulation systems which are used as such or a building block for the brand. For instance, Rainforest Alliance standard is used in Chiquita<sup>96</sup> bananas,

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95 See e.g. about the responsible biofeedstock supply and traceability of palmoil <http://www.nestleoil.com/default.asp?path=1,41,11991,12243,12328>

96 Read about the Chiquita and Rainforest Alliance co-operation <http://www.iisd.org/business/viewcasestudy.aspx?id=109>

Lipton's tea, Mars chocolate etc. In food industry B2B standards like BRC can be used as a basis for the company level ORKLA food safety standard<sup>97</sup>.

Orkla Brands is a member of Sedex, the Supplier Ethical Data Exchange, which is an international organization that offers a good, efficient system for collecting information on suppliers' working and environmental conditions and carrying out risk assessment of these conditions. Sedex is based on the manufacturer itself providing its customers with information on its own activities, a system that saves time and money for both suppliers and their customers. It is designed to enable auditing working conditions at manufacturers several links further up the supply chain. If the manufacturer's responses indicate serious breaches of the Orkla Supplier Code of Conduct, Orkla can visit and inspect the manufacturer's premises, or monitor conditions in some other way. Sedex has developed a standardised system for monitoring working conditions at supplier facilities, the Ethical Trade Audit (SMETA).

Producer-driven value chains employ a selection of the certification systems and not just one and so do the retailer-driven value chains. A retail company mixes different product categories and value chains and has therefore a need for a number of the certification systems.



**FIGURE 11.** *Self and private regulation from reactive and proactive perspective (Sorsa 2011a).*

97 See more about the Orkla Brands <http://www.orkla.com/Sustainability/Responsible-purchasing/Sedex>

The role of different certification schemes for value chain management, are summarized in Figure 11. Some of the schemes are not normally communicated to the final consumer by means of a logo or a label and therefore certification does not result in a price premium. However, most retailers demand certification of their suppliers, thereby making it a de-facto requirement for market access (Agri 238, 2009, 4). The use of these standards and the codes of conduct has become important to international value chains. In some of the EU Member States they are accepted as a sign of due diligence.<sup>98</sup> Instead, schemes with a logo are used for managing opportunities and for creating new markets. This is emphasized also in public innovation policies.

#### 4.3.4 B2C relationships

The role of different certification systems in the management of global value chains can be understood by considering the role of quality to the consumers. Quality is important to consumers and customers when they make decisions to buy goods and services and when they are wondering about how much they are willing to pay for them. Sometimes, however, customers find it hard to judge the quality offered by the suppliers (OFT 1059, 6). Customers can sometimes face a bewildering variety of different products and find it hard to assess which are suited for their purposes. If buyers cannot distinguish high quality from low quality before the purchase, then it is hard for the high quality seller to sustain a price premium. In the absence of this premium, and if the high quality seller's costs exceed those of the low quality seller, then the former may not be able to survive. Bad seller's (who sell low quality produce) drive out good quality sellers by undercutting them. This kind of information asymmetry between buyers and sellers could lead to a severe market failure (OFT 1059, 6).

Quality does not merely include the immediately provided physical product or service; it can be more broadly defined to include customer service, information provided and the after sales care. Quality can be partly derived from the inherent features of the product or service, such as the cost of the materials and the cost of the assembling techniques (or the cost of training the service provider) (OFT1059, 16). Quality includes also the production

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98 In the UK, many different retailer control schemes were designed to meet the legal obligation of the UK 1990 Food Safety Act, the basis of food law changed from one of strict liability to a recognition that problematic incidents can and do happen no matter how diligent a manufacturer is. Since then, if a manufacturer can show that all reasonable precautions have been taken and all due diligence applied so as to prevent a food law offence occurring, then the courts will accept that as a sufficient defence. (Agri 238, 2009, 4)

processes. Consumers are more and more interested in how the merchandise is produced in the developing countries. They might boycott articles produced in sweatshops or by using raw materials which cause environmental problems. (Sorsa 2010c)

Quality is, however, arguably more than the inherent features. It is also, to some extent, the utility of a product to individual consumers. In other words, quality varies from a person to person depending on their tastes, preferences and expectations. Quality therefore cannot always be ranked from low to high (basic to superior), with everyone preferring superior, if the price were the same (OFT 1059, 16).

Which aspect of quality is important will vary from product to product. The quality of a battery, for example, is likely to be mostly determined by the inherent qualities and limited to the battery itself. However, quality of a sweater is likely to be more complicated determined not only by the inherent features such as the materials used, but also by individual tastes and the sales service provided by the retailer (OFT 1059, 16).

When customers find it hard to judge the quality offered by suppliers, this problem is referred to as asymmetric information primarily because suppliers know what the quality is, but customers do not. It can be particularly hard for consumers to judge quality if an important aspect of the goods or services is not observable until after the purchase or is never revealed. This includes situations where it is difficult for consumers to be sure that the business will stay in the market long enough to deliver on their promises (OFT 1059, 6).

The European consumer policy has focused mainly on contract law: the way in which businesses approach the consumer, the pre-contractual information duties, the means of conclusion of a contract, the performance of the business, the withdrawal from the contract. Statutory law is not enough, however, and self and private regulation can offer an alternative. (Sorsa 2010a, 213)

In a business to consumer relationships, different origin labels (The Key Flag) or eco-labels (The Swan<sup>99</sup>, Eco-Flower) play a relevant role in offering consumers the possibility to make better choices regarding the product and process characteristics of their purchase and in order to raise trust in the image of the business in general (Sorsa 2009d, 44–51; Agri 238, 7; Deloitte 2009).

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99 The Swan is the official Nordic eco-label, introduced by the Nordic Council of Ministers. The green symbol is available for around 60 product groups for which it is felt that eco-labelling is needed and will be beneficial. <http://www.ymparistomerkki.fi/en>

The Key Flag is issued by the Association of Finnish Work. It is a registered collective trade mark that proves a product or service to be Finnish-made. The right to use the Key Flag symbol is issued on application to the origin mark committee of the Association of Finnish Work. The Key Flag may be used for brand marketing and corporate profiling, with some reservations. The right to use the Key Flag is issued for a maximum period of three years at a time. The Key Flag products and services must be produced in Finland. Furthermore, at least 50 per cent of the organizations' production in terms of cost value must be of Finnish origin. The use of the Key Flag is regulated by the Association of Finnish Work, which has been promoting Finnish know-how for over 95 years.

Eco-labels which are based on self-regulatory systems also play a relevant role on all sectors. Furthermore, there are also eco-labels based on EU regulations<sup>100</sup>. In the Nordic countries the two eco-labels, one based on self-regulation and another based on EU regulation, are competing with each other. The EU Eco-label is currently under revision. In the Nordic countries, the Swan label is better known than the EU Eco-label. The aim of the revision process is that the Eco-label would be harmonised nationally and globally with other labels, and that the Eco-label would be attained by companies for limited costs and efforts while still maintaining a high ambition<sup>101</sup>. From the consumer viewpoint one could ask whether we need so many different eco-label systems, as from the consumer's viewpoint the large number of standards and their diversity can be confusing.<sup>102</sup>.

From the retail business viewpoint different labels are a source of differentiation. A retailer chooses different labels in order to create an image for the company. On the other hand, in the retail sector the labels produced in self-regulation systems face more and more competition by the so-called private labels which the big retail companies have introduced. From the consumers' point of view this trend is welcome, because it usually leads to lower consumer prices. In a food value chain the self-regulation tools are used in order to guarantee the quality or safety of food products or production, and also in order to communicate this to the final consumer by a means of a logo or label. (Sorsa 2009d, 127; see also Sexsmith and Potts 2009, 47–59)

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100 The European Eco-label is a voluntary scheme, established in 1992 to encourage businesses to market products and services that are kinder to the environment. Products and services awarded the Eco-label carry the flower logo, allowing consumers – including public and private purchasers – to identify them easily. The voluntary nature of the scheme means that it does not create barriers to trade. On the contrary – many producers find that it gives them a competitive advantage.

101 [http://ec.europa.eu/environment/ecolabel/about\\_ecolabel/revision\\_of\\_ecolabel\\_en.htm](http://ec.europa.eu/environment/ecolabel/about_ecolabel/revision_of_ecolabel_en.htm)

102 Same conclusion was received in Agri 238, 7; van Yperen 2006, 59 and Nadgrodkiewicz 2009, 4.



According to a study released in 2009 by the Grocery Manufacturers Association (GMA) and Deloitte in the USA, 54% of shoppers said that they actively considered environmental sustainability characteristics in their buying decisions. “We found that for most shoppers the sustainable considerations are an important tie-breaker when deciding between two otherwise equal products and they are a driver in product switching,” said Brian Lynch, GMA director of sales and sales promotion. “But it’s not enough to just put green products on the shelf. We have to better educate consumers and leverage in-store communication to make the sale.” (GMA/Deloitte Green Shopper Study 2009).

Self and private regulation can improve the functioning of consumer law in many ways: defining quality levels, helping to make quality more observable, resolving problems when rules on quality are not met (i.e. providing advice, sanctions and redress), and increasing the likelihood of businesses getting caught cheating. Self-regulation can define quality levels by setting standards<sup>103</sup>, issuing codes of practice or codes of conduct, issuing licenses accreditation or certification needed to operate in the market and/or issuing guidance (see. e.g. Sorsa 2010d, 87–97). These systems can be more effective than consumer law, because they can focus and tailor rules to a specific industry or issues found within that industry. They can also update rules more quickly to respond to market changes. Self-regulation can also offer advantages by setting the quality standards higher than provided for in consumer law, and pursue the spirit rather than the letter of the law. On the other hand, self-regulation can offer benefits by providing additional mechanisms and resources to help consumers identify these quality levels by offering publicity to businesses in the form of consumer signposting (logos and symbols), by demanding transparency and publicizing quality commitments, making codes of practice publicly available, or making transparent registration a requirement.<sup>104</sup>

In the enforcement phase, self-regulation can promote the standards set by resolving problems when rules on quality are not met (advice, sanctions and redress). One effective way to promote standards is to give advice to businesses to help them comply with legal standards (e.g. clarifying the law to businesses),

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103 Self-regulation is often designed to deal with the “important trivial” like more detailed issues than the law stipulates, or it can complement the legal rules etc. The Blue Book 2007, 13.

104 OFT 1059, 36–3. In Europe, private regulation has more recently been considered within the frame of governance, and better law making. The focus on better regulation has been directed to improving quality and effectiveness of legislation and public regulation. The most well-known sector-specific regime associated with the new approach is technical standardization, but in the field of consumer law references to private regulation are frequent. Other fields are environmental law, professional services, banking and financial regulation. Cafaggi 2009, 9–10.

scheme stipulated standards or industry best practice (by reminding firms of best practices or by providing training). Self-regulation organizations can focus and tailor advice to specific industry problems, which can be more difficult for legal enforcers. They can also invest more time, effort and resources to providing advice than legal enforcers. (OFT 1059, 37)

Other ways to promote standards are to provide sanctions against those who break them and to allow for redress mechanisms to compensate those who have been cheated. Self-regulation schemes can also help consumers to navigate through the existing systems and raise consumer awareness of rights (e.g. providing guidance material). Self-regulation schemes can also provide a broad variety of sanctions: warnings, fines, naming and shaming (which can attract adverse publicity and so increase reputational damage). The ultimate sanction is also the ability to exclude a member even though they may still be legally allowed to trade. (OFT 1059, 38)

Self-regulation schemes can help increase the likelihood of a business to get caught lying about quality, because they can increase the effort and resources on detecting and monitoring quality issues. They can also prioritize where consumer enforcers would not, and in some cases go beyond even what a more resourced consumer enforcement agency might see as its remit. Schemes could also monitor more proactively by running consumer complaint mechanisms, by performing mystery shopping exercises, or by more rigorously checking and requiring businesses to provide proof of quality, such as copies of terms and conditions or qualifications certificates. Self-regulation also aims to change consumer behaviour by encouraging consumers to seek out reputable businesses that publicly agree to abide by rules of the regime. (OFT 1059, 39).

The restrictions of self-regulation relate to competition law, because self-regulation can have an obvious negative effect on competition. Under Article 81 the EC prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which may affect trade (either within one Member State or between the EU Member States) and which have the object or effect of preventing, restricting or distorting competition, unless they meet certain exemption criteria. Besides these decisions of self-regulatory bodies, competition concerns may also arise in relation to cooperation between the members of the self-regulation scheme if this has the object or effect of preventing, restricting or distorting competition. Self-regulation agreements

or decisions that regulate quality could themselves dampen competition (particularly by raising barriers to entry) if

- they have asymmetric impacts<sup>105</sup>
- they result in quality levels which are too high<sup>106</sup>
- they result in businesses gravitating towards one quality which reduces choice
- they limit innovation
- they limit competition through conduct restrictions<sup>107</sup>
- they prevent inefficient businesses from failing<sup>108</sup>.

The role of a government is to palliate the competition effects by drafting principles, which provide guidance to generating successful self-regulation outcomes. (OFT 1059, 44–47)

#### 4.4 SUMMARY

Contracting always takes place in a certain context. Contracts and private regulation standards are effective tools for managing commercial relationships – both between two contracting parties as well as relationships in the value chains. Contracts are not the only management tools, however, as the relational issues and long term co-operation are the other cornerstones for good business relations. In order to take full advantage of contracting one needs to be able to analyze the different contractual relations and their special characteristics.

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105 Minimum quality requirements set by a scheme might advantage some businesses over others; products are interpreted by consumers as having quality level which isn't reflective of true quality.

106 Barriers to entry are created for setting high quality standards: lower quality providers are excluded from markets, which means that those who would like to buy lower quality cannot do so, and the competition is dampened as the range of quality competition narrows.

107 Restrictions on advertising can dampen competition, because advertising is one mechanism through which businesses compete.

108 It could occur if due to membership of a self-regulation scheme inefficient businesses could benefit via their association with efficient ones.

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# 5 APPLICATIONS: PROACTIVE RISK MANAGEMENT

*René Franz Henschel*

The focus of this section is closely connected to proactive behaviour in management and law, namely risk management.

Risk management can be defined as a practice with processes, methods and tools for managing risks. The origin of the term risk is said to be the Latin word *risicum* (a cliff or rock), which derives from a Greek expression used by sailors to describe sailing in uncharted waters (Møller and Henriksen 2009). Later, in the Middle Ages, risk methodologies began to develop in mathematical sciences, but it was not until the 1950's that risk management developed into a real distinct business discipline.

In the 1960's, risk management was first developed as technical risk management and then as financial risk management. It further progressed as project risk management and then as specific business risk management. The development of risk management culminated in the year 2000 when the enterprise risk management systems emerged. Today, risk management is also seen as a strategic management discipline. The most important feature of this development is that risk management has evolved from an *ad hoc* separate process in separate silos into top down systemic and advanced business strategies on how to manage risk intelligently – which is now known as risk intelligence (Møller and Henriksen, *ibid.*).

Risk management can generally be defined as proactive pursuit that is undertaken in order to prevent certain risks from materializing and a real crisis emerging. The basic idea is that, in general, it is less expensive to implement risk management and prevent problems from occurring than act reactively when the risk has materialized or only after the risk has already developed into a real crisis. Both risk and crisis managements are therefore closely connected to the protection of values, earnings and reputation. A particular part of risk management is quality risk, which will be briefly described below.

In addition, there is a potential in risk management that many companies and organizations overlook, namely the ability to optimize and create value, also called opportunity management. By the same token, proactive management and proactive law do not only aim at managing risk and preventing crises, but also at achieving business success to the fullest extent possible. On opportunity management, see above. In the following paragraphs, the fundamentals of risk management and how they relate to proactive contracting and contract management will be described briefly.

Risk Intelligence is a maturity level where risk is managed, not necessarily eliminated, and where risk management is an integral part of the organizations' culture. In the last maturity level, risk management is not only about controlling risk, but also looking for opportunities, and using risk management as the management discipline (Møller and Henriksen, *ibid.*).

The term "risk" is not a uniform concept and there are at least 10 different definitions of risk, among which some focus on uncertainty, while others focus on probability or consequences. This is one definition:

*Risk refers to uncertainty about and severity of the consequences (or outcomes) of an activity with respect to something that humans value. (Aven 2007, referred to by Møller and Henriksen, *ibid.*)*

Sometimes a division can be seen between risk management in specific areas of the enterprise, which is conducted in order to fulfill the objective within each individual business area of the company (e.g. in finance, legal department and project management) on the one side, and on the other side risk management seen from the point of view of the entire enterprise, also called "risk leadership". However, it is not either/or; risk management has both a strategic and an operational level, and the different areas must communicate in order to function properly.<sup>109</sup>

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109 See Møller and Henriksen, *op.cit.* 9, on *ex ante* and *ex post* risk management. See also European Risk Management Institute, <http://www.eirm.com/en/Risk%20Leadership.aspx>: "In recent years, the term risk leadership has emerged as a way to isolate and explain that set of activities within the broader risk management field that deal with the setting of risk policy and strategy, the effective organization-wide effort to communicate and educate, and the measures necessary to coordinate wide-ranging specializations and to assure that risk management is practiced in accordance with strategy. Because the concept of risk leadership is so obviously connected to organizational strategy, governance and compliance concerns, it has become to some extent identified as a director and executive level issue. In EIRM's view, that identification is mainly correct. However, risk leadership is (or can be) an aspect of any person's job. Line managers, shop stewards, sales managers, and supervisors all can identify aspects of their jobs as 'risk management'. And, in the sense that they too must align their efforts with goals and objectives, communicate effectively, and assure performance, they too are practicing risk leadership."



## 5.1 RISK MANAGEMENT AS A GENERIC BUSINESS PROCESS

The modern approach to risk management is based on a six-step methodology. Its aim is to identify, evaluate, handle and control the different risks in a systematic way. There is a range of different tools and methodologies that can be applied, depending on the line of business and its approach to risk management, e.g. COSO,<sup>110</sup> AS/NZS,<sup>111</sup> FERMA,<sup>112</sup> DeLoach<sup>113</sup> and many others. However, the basic methodology overall seems to be more or less the same, although some differences may be seen between them, e.g. in relation to the connection between risk strategy and operational risk management, communication across the organization (out-of-silo communication), the search for opportunity management,<sup>114</sup> top-down or bottom-up management and involvement<sup>115</sup> and the tools used for identifying and assessing risk, e.g. internal or external stakeholder view. The latest model is the ISO 31000:2009, which is characterized more of being principles and guidelines rather than standards, which can be explained by the fact that it is difficult to standardize management. Therefore, ISO 31000:2009 does not amount to a certification.<sup>116</sup>

The first step is to define the goals and strategies of risk management. This is done on two levels, both as an overall business risk management strategy and more specifically for the individual handling activities. The next step is to identify the different risks that can occur in the organization, e.g. technical, financial, operational and legal risks. Therefore, a broad range of different methodologies specific for each business area, like PESTEL-analysis, questionnaires etc. may be used.

The third step is to evaluate each of the different risks, e.g. based on a risk mapping model, where a) the likelihood and b) the impact is drawn into a two-dimensional Risk Map. The fourth step is to define the response to the risks identified and evaluated. Typically, enterprises operate with five different categories:

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110 <http://www.coso.org/>

111 <http://www.standards.co.nz/default.htm>

112 <http://www.ferma.eu/>

113 DeLoach and Temple: Enterprise-Wide Risk Management: Strategies for linking Risk and Opportunities (2000).

114 See especially Deloach/Temple and AS/NZS, and Møller and Henriksen, Ibid.

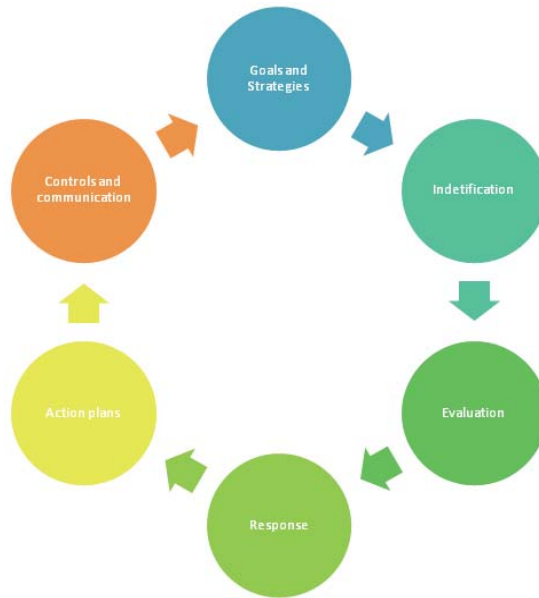
115 Here, COSO is top-down while AS/NZS is bottom-up which makes Møller and Henriksen to conclude, that COSO fits vertical and hierarchal organizations best, while AS/NZS best fit horizontal organizations, e.g. as in the Scandinavian enterprise models.

116 See [http://www.iso.org/iso/catalogue\\_detail?csnumber=43170](http://www.iso.org/iso/catalogue_detail?csnumber=43170)

- avoidance
- reduction/mitigation
- share/transfer
- accept
- exploit.

The choice between these 5 categories depends on a cost/benefit analysis based on the likelihood/impact analysis. If one imagines that the risk is natural disasters and outsourcing, e.g. the risk of earthquakes having impact on production, the first one, avoidance, would be avoiding production in areas threatened by earthquakes. The next one, reduction/mitigation, would be to divide outsourcing activities into risk and non-risk areas. The third, share, would be to share or transfer the risk, e.g. to an insurance company or business partner. The fourth would be simply to accept the risk. The fifth would be to try to exploit the opportunities the risk offers.

Especially the last mentioned is often neglected in risk management. Although it may be hard to find opportunities in all risks, e.g. as in this case about earthquakes, other risks may give opportunities for business which is often not pursued by enterprises. Here, risk management develops into opportunity management, as explained above. This has importance for proactive management and proactive law as well. The fifth step is to develop action plans based on the risk that have been prioritized for action. Usually this action plan involves a risk manager and a risk owner, who are not (necessarily) the same person or organization. The risk owner has the ultimate business responsibility of the risk, while the manager is responsible for taking care of the process mitigation of the risk. The final step is to introduce activities that can control risk management and strategies, e.g. performance measurements, physical controls and reviews. This should not only be done in a mechanic and routine way, but in a way that allows creativity and innovation, so that the organization is also aware of new risks and opportunities that might develop. This generic risk management process can be illustrated as below in Figure 12.



**FIGURE 12.** *The Generic risk management process.*

This model can be used on all levels of the organization, but it must be supported by the necessary processes, techniques and tools, e.g. IT. It is important for a successful process that the culture in the organization is open, honest and straightforward, where people are not afraid to disclose their fears or errors they have committed, and where they are not sanctioned for their openness. Therefore it is important that the top-management dares to go first and introduce the open, honest and straightforward risk culture (Møller and Henriksen 2009, 14). The six-step model described above can also be used to control different business risks, including quality risks and legal risks, as described in the following sections.

## 5.2 RISK MANAGEMENT, LEGAL RISK MANAGEMENT AND PROACTIVE MANAGEMENT

Disciplines such as business management, engineering and computer science use a variety of methods to manage risks of different kinds related to, for instance, products, markets or information systems. The “risk” may be economic loss, negative effects on the security of a system, a delay in system

development etc. Legal risks can also be managed through different methods, although legal risk management methodologies still seem to be in their infancy.

Lawyers sometimes use the term “legal risk management” in the marketing efforts of law firms to advertise or promote their services, mainly addressing the corporate client. The use of the term “risk management” in a legal context could be taken to imply that there is a clear understanding of how methods for risk management can be applied within the legal domain. However, in most cases the term is probably used in an informal sense, indicating that lawyers will offer their services to clients with the objective of reducing risks, typically of economic nature, but also of getting into future disputes (with the implied costs and economic uncertainty of such a situation). The use of the phrase is not always explained with reference to a certain method or standard.

By comparison, other disciplines use the term “risk management” as a reference to a well-defined approach, a specific method, or a set of specific methods. According to the ISO, risk management “involves applying logical and systematic methods for [...] identifying, analyzing and treating risk with any activity, process [or] project [...]”.<sup>117</sup>

In law, there has been an increasing focus on legal risk management and the methodologies that have to be applied. (See e.g. Mahler & Bing 2006, 339) The conclusion seems to be that methods from risk analysis and risk management can be used to enrich the legal methods in a proactive context. Sometimes the use of proactive or preventive law is even seen as identical to legal risk management. (Dauer 2006, 93).<sup>118</sup> However, it must rightfully be concluded that legal risk management still needs more research to be done in order to be fully developed (Mahler and Bing, *Ibid.*) Nevertheless, some guidelines of legal risk management can be described. In the following section, the most important features of traditional legal risk management are discussed.<sup>119</sup> After this, proactive risk management is described in 5.2.3 below.

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117 ISO 31000 (2001) and ISO Guide 73.

118 Dauer 2006, 93: “The objective of Proactive Law is the management of legal risks through identifying, anticipating and planning for it in advance”.

119 The description is based on among others, Iversen: *Legal Risk Management*.

## 5.2.1 Traditional legal risk management

The traditional element in legal risk management is the focus on legal issues in the context of risk. This legal perspective on risk becomes visible in the identification of *legal risks* and in the use of *legal measures* to treat risk. Legal risk management can thus be defined as a structured approach which focuses on managing a particular set of risks, namely (1) legal risks and (2) risks that can be “treated by legal means”.<sup>120</sup>

From a strategic point of view, legal risk management has traditionally been closely connected to corporate governance.<sup>121</sup> As part of good corporate governance, the enterprise also needs legal governance in place. This governance structure is often designed and taken care of by the legal department, which also has the responsibility to implement the chosen processes and tools to fulfill the risk management strategy.

As part of this legal governance, legal compliance or regulatory risk management is often very important. Regulatory risk management can be described as the process of ensuring that an organization follows relevant laws and regulations, e.g. competition law and the Sarbanes-Oxley Act of 2002 (U.S. Public Company Accounting Reform and Investor Protection Act of 2002). Furthermore, compliance with industry standards and CSR, codes of conduct etc. is also seen as important part of the compliance issue.

Structural risk management, Contractual risk management, Litigation risk management and Document risk management are different kinds of examples of managing the risks of different enterprise-units. Although traditional legal risk management has been aware of the importance of processes, tools and techniques for managing risks, most often traditional legal risk management has not been conducted in interdisciplinary or cross-professional teams.

## 5.2.2 Proactive legal risk management strategies and methodologies

If we conceptualize proactive legal counselling as a type of risk management, then we can apply and potentially benefit from the structured approach offered in standards and methods for risk management.

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120 See e.g. the use of such traditional method, Trzaskowski 2006, 319.

121 See Iversen, *Ibid.*

First of all, legal risk management must be elaborated on both a strategic enterprise level and on a domain specific level (See Mahler and Bing, *Ibid*, Iversen, *Ibid*) using the proper methods developed for the different areas. Developing a legal risk strategy in a vertical, hierarchical company structure may be based on the COSO standard, while horizontal integrated organizations may be based on the AS/NZS.

The development of legal risk management on an operational level may be based on the appropriate methodologies that fit the particular legal domain. As an example, information and communications technology related legal risk management can be mentioned, where the use of the CORAS risk methodology<sup>122</sup> may be applied. CORAS is a framework for risk analysis of security critical systems with large amounts of information being transferred. CORAS has been recommended for use in legal risk management in an ICT context where interdisciplinary cooperation needs to be carried out in order to identify, evaluate and respond correctly to the risks involved in an ICT project. The CORAS methodology uses graphics to illustrate the risk, and in that way it facilitates interdisciplinary communication so that the risk can better be understood and managed (Mahler and Bing 2006, 355). The research done so far indicates that legal risk analysis will benefit from being carried out jointly by experts from different disciplines, including, for instance, lawyers, economists and computer scientists, and that this interdisciplinary communication may also work to reduce the legal risks involved in the project (See Mahler and Bing, *Ibid*, with note 35). Using traditional legal risk management in combination with other risk methodologies thus indicates to be beneficial in risk management, both on a strategic and operational level.

Another example of risk management in a specific domain is contractual risk management, which will be the subject of the next section. The idea of the section is to show how traditional contractual risk management may hinder innovation and new opportunities, if done in the wrong way.

### 5.2.3 Proactive Contractual Risk Management

Essential features of proactive contracting are risks and risk management. Therefore, contract preparation and negotiations are the salient poles. Risk and uncertainty describe the possibility of different potential outcomes. Some

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122 [http://www.ercim.eu/publication/Ercim\\_News/enw49/dimitrakos.html](http://www.ercim.eu/publication/Ercim_News/enw49/dimitrakos.html)

systems feature inherent randomness, such as games of chance. In business, the risks and uncertainties reflect unknowns and variability in nature, materials and human systems (Schuyler, 2001). Risks can be divided into harmful and beneficial risks. A harmful risk can be, for example, a situation the enterprise does not want to fall in, e.g. liability in case of breach of contract. A beneficial risk can be seen as a course of events in which some positive effects can materialize, for instance, that the company can create innovations, if they accept a certain liability, but there are still some uncertainties and questions concerning them (Henschel, 2009; Määttä, 1999).

In the context of contractual risk management, risk as a concept can be determined as well. One definition emphasizes comprehensively proactive views on risks. Firstly, a distinction between danger and risk has to be made. The conclusion is that dangers that can be avoided are risks, but dangers that cannot be avoided remain true dangers. With this distinction, the significance of the extent to which dangers are avoided should also be noted. In this sense, all dangers are risks when their consequences can be minimized. Secondly, risks and liabilities should also be distinguished (Keskitalo 2000).

Traditionally, risks have been defined and allocated retrospectively after the conclusion of a contract and the realisation of risks. That is why risks are often identified with liabilities, but when the proactive nature of risks is overlooked, the fact that rationalising risks and internalising them to the decision making process is actually a tool for planning contracts is dismissed. Therefore, risks should be handled prospectively and liabilities retrospectively. The concept of liability is linked equally to risks and dangers, since liability as a term illustrates both the legal consequences of risks and dangers. In terms of proactive law, risks and dangers are potential liabilities (Keskitalo 2000).

The question about risks, dangers and liabilities is very often the subject to intense negotiation between the parties. The International Association for Commercial and Contract Management (IACCM<sup>123</sup>) is a worldwide non-profit organization. For the last decade, IACCM has conducted an annual survey of the 'most frequently negotiated terms and conditions'. The study usually attracts input from more than 4,000 qualified participants from legal, procurement, contract and commercial management groups worldwide. Almost 1,000 corporations and organizations are usually represented.

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123 See [www.iaccm.com](http://www.iaccm.com)

In the survey of The International Association for Commercial and Contract Management (IACCM<sup>124</sup>), negotiators report that they remain entrenched in fighting traditional battles. The top negotiated terms remain largely unchanged, and among them are liability disclaimers and indemnities. If anything, the focus in recent years has become more protective and risk averse. According to IACCM's survey, it has become clear that the commitments and obligations required to compete in today's highly competitive and fast-changing environment have changed. Yet the rules and the procedures by which contracts are governed have not. External influences such as regulation have combined with the traditionalism and parochialism of the law to stifle adaptation.

Specifically, the global economy has swung increasingly towards services. Most major manufacturers have sought to avoid the pressures of 'commoditization' by moving towards packaged solutions and services. In addition, new forms of contract relationship – such as outsourcing – have become common. All these relationship types demand outcome-based commitments, weakening the traditional principle of *caveat emptor* and making the ability to bear and manage risk into a source of competitive advantage.

As if this shift in value propositions were not enough, IACCM have also witnessed an era in which the speed of change has augmented the role and purpose of contracting. Successful deals that deliver economic value require lifetime management. The contract and the process through which it is created and managed become key instruments for relationship governance. Traditional contract standards and the focal areas for negotiation help little in providing such a framework. Liabilities, Indemnities, IP rights, Liquidated Damages are all topics that prepare for failure and disagreement. They are at best negative incentives and in general, imbalance in the negotiated allocation of risk results in an environment of self-protection, constrained information flows and a culture of blame. We may well ask, if today's contracts are focused on protection, is that really a bad thing? After all, lawyers and contract negotiators are charged with protecting the company or organization from risk.

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124 See [www.iaccm.com](http://www.iaccm.com)



### 5.3 SUMMARY

The reason why today's focus is wrong is because it is lop-sided. It concentrates on assumed failure and does little to establish the framework for success. It does not manage risk, because it fails to enable opportunities, growth, or mutual benefit<sup>125</sup>. The focus of negotiation today stifles collaboration and results in many contracts being dangerously incomplete when they are signed. This is because battles over the allocation of risk frequently prolong negotiations and divert attention from the real issues, which are what the parties want to achieve and how best they can do it.

Furthermore, the battle over indemnities and liabilities often overlooks the negative consequences and an adverse attitude towards risks. If an enterprise forces harsh liability clauses over a supplier, the supplier may want to reduce its risk by not offering the enterprise innovative solutions, because innovative solutions sometimes increase the risks for initial problems, e.g. with adjustments. Therefore, the supplier will either decrease the investment in innovation, or offer the innovative products and services to other enterprises. Thus, an aggressive legal risk management strategy in liability clauses may impact innovation risk strategies (Henschel, 2009). Consequently, the company must start to think in an interdisciplinary way about risks and opportunities in order to fully develop the right strategies. Furthermore, the way opportunities are handled needs more attention in relation to risk management, because a rigid and adverse risk management strategy can negatively affect opportunities. In reality, we see a need for developing explicit opportunity management strategies and methodologies also as part of a proactive approach to management and law. This will be explored in the section below.

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125 In order to assess bid or no bid mechanism practical tools can help to manage the process proactively, see e.g. "Bid/No-Bid Decision-Making – Tools and Techniques [http://www.fctcenter.com/sites/default/files/Bid-NoBid\\_US\\_DI\\_whitepaper.pdf](http://www.fctcenter.com/sites/default/files/Bid-NoBid_US_DI_whitepaper.pdf)

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# 6 PROACTIVE CONTRACT MANAGEMENT

*René Franz Henschel, Kaisa Sorsa & Tarja Salmi-Tolonen*

In the chapters above, proactive contracting and risk management and their importance in maximizing the successful outcome of business activities were discussed. In this chapter, the focus is on contracts and how proactive management of contracts can improve business success.

Generally speaking, contracts are the linchpins, which hold together the business relationships in a networked economy. *Contract management* can be defined as an advanced method in which an organization applies quality principles to its business terms, policies, practices and processes in order to improve and optimize the negotiation, execution and governance standards of its contracts. By using its contracts systematically the company ensures that the formal commitments are tailored to the business needs and opportunities, so that the selection of business partners and business relationships are optimized, and the contracts can be executed as agreed. This is why contract management can be seen as an activity equivalent to commercial management (Cummins, David, Kawamoto, 2011, 7).

## 6.1 PROACTIVE MANAGEMENT AND PROACTIVE CONTRACT MANAGEMENT

Different types of contracts may have different kinds of strategic importance to a company or an organization. In proactive management, the company knows what the impact of their contracts is on their business outcome and how proactive law can be used to implement business strategies.

## Example

Imagine a contract for cleaning services. Cleaning services may be of strategic importance to a private hospital or to a company that produces parts for satellites, but not to a company that only consumes standard office cleaning services. Consequently, different contracts and governance models have to be used for the same type of services. A strategically important contract needs to use techniques that reflect the parties' vested interests in the contractual relationship. This calls for close collaboration, e.g. clearly defined outcomes, performance management and relationship management (Vitasek et al, 2011). On the other hand, if the service is non-strategic, then the price is usually a decisive factor and the contract design may be more traditional and based on arms-length principles. If the service provider does not perform according to the agreement, this does not affect the strategic goals of the company. Consequently, the contract could be avoided without serious consequences, and the service provider replaced by another service provider without seriously compromising the business success of the company. The same is not possible in a strategically important service contract where the service provider has gained knowledge about production planning etc. in order to maximize its cleaning services (e.g. how to avoid dangerous diseases from spreading in a hospital, or how to avoid dust in the microchips for satellites). Thus, the contracting and risk strategies, and consequently the contract management strategies, may differ from one contract to another.

Before developing the proactive contract management strategy, it is therefore necessary to determine the importance of the particular contract in the overall value-chain of the company or organization, and then to fit the contract and its management to the particular conditions (Cummins, David, Kawamoto 2011, chapter 2). Also, tailoring the services so that they could be subject to a contractual relationship should be considered, i.e. so that it would be possible to measure and document performance. If this is not possible, the service design should be re-considered (cf. Rekola and Haapio 2009).

## 6.2 FROM REACTIVE TO PROACTIVE CONTRACT MANAGEMENT

Research on outsourcing may be used to illustrate the difference between reactive and proactive contract management. Research (Cohen and Young, 2006) has shown that companies often do not reach the desired goals in an

outsourcing deal. Up to 50% of all outsourcing deals fail to accomplish the desired outputs. There are various reasons for this, but typically, the reasons are:

- lack of proper pre- and post-award communication, e.g. demands not accurately described
- lack of proper “interfaces” and communication between the supplier and the customer
- the internal organization of the customers is not geared to manage or control the contract, internally or externally, in accordance with what is agreed (e.g. performance management)
- in general, a lack of standardized internal and external management of the contract. (Cohen and Young, 2006)

To reach a more successful performance, four themes are described within the best practice of outsourcing:

- There must be a planned and integrated sourcing strategy.
- It is supported by good governance (command-) structure (integration, enforce, modify/adjust).
- Sourcing should not be based on a transactional mindset, but on a mindset built on partnerships and trust.
- Sourcing requires an establishment of meaningful and verifiable objectives, which help contract managers and others to reach the desired business outcomes. (Cohen and Young, 2006)

We see here a striking parallel between the research on proactive law and contracting and proactive management. In the sourcing literature, this new approach called *multisourcing or vested outsourcing* recognizes a holistic and systematic approach to sourcing where long-term strategy is implemented in order to pursue business goals. By maintaining a constant focus on the assurance that it is a common goal (internally and externally) to meet business goals, and by recognizing the interdependence and vested interests between the customer and the service providers, the company should handle proactively the facts that are important for a successful business deal (See Vitasek et al. 2011, who put up ten main principles for reaching successful outsourcing deals, see further below).

An important first step is to recognize the connection between business goals and the individual contractual relationships. Typically, outsourcing contracts – and with modifications some other contract types as well – can be divided into three categories.

1. Cost improvement focused contracts which are primarily focused on efficiency.
2. Operations performance improvement focused which primarily focus on the enhancement of the business performance.
3. Business performance improvement focused which primarily aim at transforming business performance.

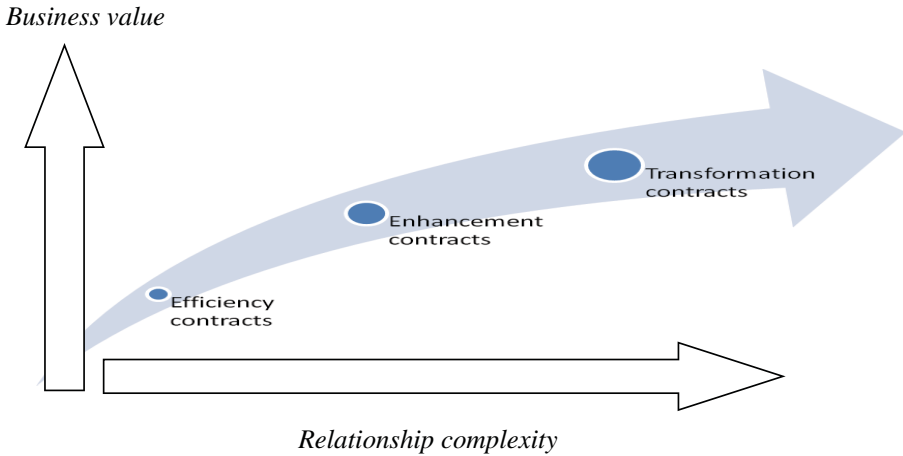
An example of category 1 contracts (*efficiency contracts*) could be a contract for billing or phone services, mainframe operations or desktop computing support. These types of contracts will typically concern commoditized products and services. Such contracts usually focus on service level agreements, “quantity and quality of service delivered”, etc.

Category 2 contracts (*enhancement contracts*) are contracts which aim at product or process improvement or process re-engineering and are therefore closer to actual business goals and business outcomes, e.g. developing and managing new IT-platforms or delivering state-of-the-art cleaning services for the computer industry. Usually such contracts involve sharing knowledge of the client’s business operation, and a mutual understanding of the strategy and processes which align objectives between the two parties on an ongoing basis. These particular types of contracting relationships translate into greater levels of trust and co-management, and require contract and governance models that will keep the deal current with changes in the business environment. Furthermore, such contractual relationships typically focus on rewarding the service provider for providing value beyond the original terms of the deal. Thus, the lowest price should not be the overriding factor in signing these deals.

Category 3 contracts (*transformation contracts*) are contracts which aim to innovate and dramatically improve the very competitiveness of the organization by generating new revenues, out-maneuvring the competition, maybe changing the very basis by which the corporation operates. These types of contractual relationships therefore strike at the very heart of the company’s business model and often exist where the closest partnership and the most complex relationships are found between the parties in the network. An

example could be a turn-key construction project to build a new production facility for a pharmaceutical company, or the construction of an off-shore wind-mill park to produce environmental friendly energy to competitive prizes. These types of contracts need careful planning and implementing in order to realize the anticipated benefits and mitigate business risks that may exist. Often such relationships are based on equity sharing (bonus clauses), joint ventures and partnerships.

The different categories of contracts thus have a different impact on the business output and at the same time have different relational implications. This is described in Figure 13 below.



**FIGURE 13.** *From efficiency contract to transformation contracts.*

In other words, different types of contracts do not automatically fall into the same business strategy context. They generate different kinds of business value and consist of different degrees of relationship complexity. Consequently, they do not necessarily need the same contracting or risk strategy, or the similar contract contents or contract management governance structure. The difference between reactive and proactive contract management is thus in how the impact of contracts on business goals is analysed as well as how they set up strategies on how contracts and management of contracts can improve business results and then implement and monitor the improvements by use of the right contracts, processes and contracting capabilities.

### 6.3 THE BASIC PROCESSES OF PROACTIVE CONTRACT MANAGEMENT

Above, it was described how, for instance, sourcing deals were often not successful due to lack of proper communication, lack of proper “interfaces” between supplier and customer, and that the internal organization of the customers was not geared to manage or control the contract. In short, there was a lack of standardized internal and external management of the contract.

Implementing the appropriate proactive skills and competences must change this predominantly reactive approach to contracting and risk management. Proactive contract management demands first of all certain tools and processes. Here, interdisciplinary approaches, cross-professional communication, strategy-development and outcome orientation are particularly important.

The first step is to make sure that the different stakeholders connected through the contract by different linchpins, internal as well as external, communicate to define the business outcomes. This requires that lawyers, engineers, computer scientists, economists etc. engage in cross-professional communication and networking to understand each other and how the desired business goals can best be reached.

This should be done in the earliest stages possible, so that problems do not occur because of the right issues not having been considered at the right time (Cummins, David and Kawamoto 2011, chapter 3.2.; Kavaleff, 2006; Seidel and Haapio 2010). Here, a shared business model map and a shared vision statement and statement of intent might help parties to share their vision of business success as a platform for developing the right contract and management tools (Vitasek et al, 2011, 33). It is then important to align these factors with contract structures, terms, policies and practices in order to avoid the contract impeding business success (Cummins, David and Kawamoto 2011, chapter 1). This communication and interfacing might require special methods of communication and networking, for instance, through the use of the CORAS methodology and the UML modeling tools (see Mahler and Bing 2006).

It is then important to consider the legal, regulatory, financial and other important aspects of the proposed relationship<sup>126</sup>, and based on these

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126 See e.g. what small and emerging government contractors must know to win business with the U.S. government, part 1: <http://www.fctcenter.com/sites/default/files/CM1010%20-%2032-43.pdf>, part 2: <http://www.fctcenter.com/sites/default/files/CM1110%20-%2032-43.pdf> and part 3: <http://www.fctcenter.com/sites/default/files/CM1210%20-%2038-47.pdf>



considerations, to develop an appropriate form of contract and to address the considerations and issues that most frequently require attention. (Cummins, David and Kawamoto 2011, chapter 1) Based on the different business models and visions, and the considerations on financial, legal and other aspects, the parties may now, for instance, negotiate and create a Statement of Objectives (SOO), which describes the intended results (Vitasek et al, *ibid.*) or a more detailed Statement of Work (SOW), which comprises the different tasks to perform. The parties should also agree on clearly defined and measurable desired outcomes, and how the management of the performance should be done (Vitasek, 2011, *ibid.*). As was shown above, it is often discovered that there is a lack of management capabilities in both organizations, and this must be addressed in order to maximize the business output of the contract.

The pricing model and incentives are very important in the contract and must be agreed on. By doing this, the parties also consider the management of risks in the relationship. Finally, the parties must agree on a governance structure that supplies insight as well as oversight, e.g. relationship management and exit management. (Vitasek 2011, 33) What comes to communication between the supplier and the customer, external communication and trust-building may be facilitated by developing the right legal instruments and the right policies, procedures and methods that support the company's contracting and risk management. As examples, the use of letters of intent (see Weitzenböck 2006, 305 ff), the use of common working groups and regular project steering group meetings directly regulated in the contract can be mentioned (see e.g. Langemark et al., *Iterative kontrakter og projektmodeller* 2009).

The cross-professional and interdisciplinary communication and networking may also be facilitated by the right IT tools, for instance share-point platforms or specifically dedicated contract management software, which establish the right communication platforms and linchpins for the different stakeholders to communicate and collaborate internally as well as externally. The design has to take into consideration the proactive competences and facilitate cross-professional communication and networking. Furthermore, it has to take into consideration the different types of contracts and relationships which might impact the design of the contract management organization. In this regard, differences may be seen in the way companies design their contract management organization depending on whether it is sales contracts, procurement contracts or complex contracting that is the main emphasis in the business strategy.

To conclude, proactive contract management consists of a series of processes that involve communicating business models and creating a shared vision, establishing the right contract content to support the business outcomes, developing the right governance structures that enable insight and oversight, and finally, possessing the right management and relational capabilities to secure the business outcomes to be delivered as agreed or according to the circumstances if the contract and the parties so allow.

## 6.4 CONTRACT MANAGEMENT MATURITY<sup>127</sup>

*Kaisa Sorsa & Tarja Salmi-Tolonen*

### 6.4.1 The rationale of maturity models

Maturity models are planned and designed for the improvement of business processes. Whatever a business improvement or change process is, it has to be a long-term commitment in order to be successful. A new way of thinking is required of any management looking for transformation. This is true of any improvement programme that incorporates elements of quality assurance and continuous process improvement. The change process is made easier if there is a roadmap and a way of finding out exactly where you are on that map.

Maturity concerns development and growth, from an initial state to an advanced state, steps which one needs to take in order to reach the advanced level. In the context of business improvement, the first step would be the implementation of the programme, and the advanced level one a situation where the strategies of the programme have been fully adopted and integrated into the organization on a continuous and substantial way. (Moore 2010).

Mapping the cycle of maturity provides a framework enabling an organization to measure the health of its programme by providing a point of reference for its current state, and then consequently to guide the future direction of the programme by setting and prioritising goals, aligning functions and projects, and setting a method for future appraisal. A maturity model gives the management a method of measuring and reviewing the progress of an improvement programme. (Moore 2010).

Maturity models comprise key process areas which are the focus areas of the improvement programmes. They can vary from project management, quality management and IT issues to sustainability issues depending on the issue under development. The benefits of using a maturity model are several. An effective maturity model helps to (Moore 2010)

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<sup>127</sup> This subsection is based on the Maturity Model created by Sorsa and Salmi-Tolonen in 2009. The first version was presented at Project Management Days conference in November 2008 by Sorsa and further developed by Sorsa and Salmi-Tolonen for the IPMA 2009 conference.

- map current capabilities
- create a baseline for measuring improvement
- document the need for change
- provide a common language
- foster a culture of excellence
- set the stage for organizational change
- give top leadership insight into day-to-day practices
- help make informed decisions on workforce development and training
- focus attention on specific capabilities to be retained
- decide what new initiatives need to be developed or launched
- communicate to suppliers and customers the development of the organization.

Although there has been a need to provide guidance on the use of contracting as a governance tool since the era of networking businesses, the actual contract management maturity did not appear until Garret and Rendon (2005) used the term to describe the complex array of inter-firm relationships involved in obtaining strategic alignment with business and contracting. Effective contract management provides mechanisms that enable management to integrate business and contract management, allocate responsibilities, and prioritize contract management initiatives. International Association for Contract and Commercial Management had also started to develop its own contract management maturity model in 2007.

In the same way as risk management processes can be assessed, for instance, by reference to the ISO norms, leading organizations can also conduct an assessment of their contract management process maturity through the use of the Contract Management Maturity Model (CMMM). The key process areas of the CMMM are described in the model from the buyer's perspective as well as from the seller's perspective, and they are focused only on the different phases of contract life cycle. The CMMM© (See Garret and Rendon 2005) consists of five levels of maturity ranging from an ad hoc level (Level 1), to a basic, disciplined processes capability (Level 2), to a fully established and institutionalized process capability (Level 3), to a level characterized by processes integrated with other corporate processes resulting in synergistic corporate benefits (Level 4), and finally, to a level in which processes focused on continuous improvement and adoption of lessons learned and best practices (Level 5).

These CMMM assessment results provide a wealth of insight into the organization in terms of which key process areas in regard to contract

management need to be improved and to which programme offices to direct its improvement effort. Furthermore, the assessment results will provide the organization with a roadmap of additional needed training and education for improving its contract management process capability. For example, an organization with a low maturity level (*Ad hoc* or Basic) in the Source Selection key process area will know that it needs to provide additional training or policies and standards in the areas related to the key practice activities for that specific process area. This is the true value and benefit of the contract management process capability maturity model – the continuous improvement of the organization's contract management processes.

The CMMM model does not, however, take into account the sustainability issues which we see are a crucial element of contracting today and in the future. It does not take into account either the other elements we have seen relevant for the contract management maturity. The contracting capabilities maturity model developed by Sorsa and Salmi-Tolonen (2009) is based on the CMMM and some other maturity models (See comparison in Sorsa 2009a, 200–206) and experiences gained from Finnish companies. The importance of the contract content related capabilities was found challenging when companies transformed their business models from manufacturing and selling products to selling services, and when new contractual templates were needed for the new business models (Sorsa 2006, 94–96; 2009a, 199). Sustainability issues were also lacking from the CMMM model even though they are seen relevant issues for different businesses and also reflected in the contract contents (Salmi-Tolonen 2007; Sorsa 2008a, 2008b).

The feasibility of the model was tested in a teaching environment with students in different programmes and adult students with different professional and cultural backgrounds during 2009–2011. The foundations of the different maturity levels are described in Table 2 within the key performance areas: contract content and process related competences, relational competences as well as organizational competences.

#### 6.4.2 Contract management as an organizational capability

*Contractual capability as organizational and personal proficiency* defines the loci of the capability – the company or the individuals who have been assigned the contract-related duties. It is the company that obviously needs to possess corporate contracting capabilities, but a company is a body whose knowledge

and skills can only be incorporated in and generated by individuals (Salmi-Tolonen 2008, 11). This capability is assigned two attributes: methods and tools in addition to the assignment of roles, bearing in mind that the *organizational capability* involves organizing, managing, coordinating, or governing sets of activities from routines to sustaining competitive advantage. There must be tools, processes and methods of transferring the individual level skills and competences to company level competences and further to dynamic capabilities and to the organizational and strategic routines by which firms achieve new resource configurations as markets emerge, collide, split, evolve, and die (Murray 2003, 310). (Sorsa and Salmi-Tolonen 2009).

These elements aim at improving the use of the resource base of the project or company. By detecting errors in existing routines or finding out appropriate changes in them, or via the need for new routines and procedures (reflecting), the company can learn only at its worst case by trial and error, but as a more developed level tools, methods and procedures are embedded and integrated in other competency development processes and reflecting is part of continuous learning (Söderlund et al. 2007, 18; Sorsa and Salmi-Tolonen 2009)

### 6.4.3 Assessment tools for contract management

Organizational capability refers to deciding who is in charge of integrating the various skills, actions, documents and interests related to contracts; contractual risk management is also a part of it. The sales, procurement, project, risk or contract manager can be in charge of a major part of the whole. However, the responsibility for business contracts and for organizing their management will normally fall on business leaders and executives. Therefore, their attitude towards contracts determines how the opportunities offered by contracts are used – or not (Haapio 2007, 24).

At the *ad hoc* level (see Table 2 below), the company has not developed any specific tools or methods for contracting. People draft contracts using their own skills without any help from the organization. Contracting capabilities are typically a proficiency of one person and if s/he leaves the company, the knowledge is lost. At the *ad hoc* level, the ability to change is only very basic and *ad hoc*, because learning takes place mainly through experience in small incremental steps. Competence development will not take place in any planned sequence. However, decision making will be more flexible because of fewer procedures and systems (Murray 2003, 310). On this level, managers

and contract personnel (people who in normal business make contracts) are not held accountable for adhering to any contracting processes or standards.

At the repeatable level, competences will be developed through an effort to structure learning routines. Systems and procedures will be paramount in helping the company to learn and grow, forming the basis for prescribing how most things are done. Any major change will be reactive (Murray 2003, 310). There may be a dedicated team formed to develop contract models, processes, procedures, tools, systems and metrics for contracting and delivery processes, and process ownership is assigned to somebody.

At the functional level, the management will start to recognize the need to improve efficiency by solving problems related to doing things right. Output will be increased because of efficiency improvement and efficiency efforts will drive most learning (Murray 2003, 310). Contracting is fully established and institutionalized within the organization; clear processes, process ownership and accountability are in place.

At the integrated level, people will start to question present systems and procedures. This will lead to incongruities of present systems since existing beliefs will be challenged. Change will come from a more proactive engagement of innovation and incremental improvement creating value-added practices, processes and systems. Both management and staff will drive new learning and worldviews will be constantly challenged. The company will be starting to place a stronger priority on systems thinking and generating new knowledge will be important (Murray 2003, 310; Kerzner 2006). This is concretized in rationalizing and aligning the policies, procedures and processes across the business. In addition to representatives from other organizational offices, the other contracting parties are also integral members of the contract team.

Dynamic capability is created when critical questioning and reflection is common culture of the firm and change will be a way of life in the company. Learning will be characterized by high interpretive and integrative skills, and the internal environment will be dynamically integrated. Systems thinking will be common, and innovation and knowledge generation will be highly valued. Management skills will be highly advanced, and the devolution of decision making and responsibility widespread (Murray 2003, 310.) Contracting policies, procedures and processes are optimized and they are comparable to ISO or other standards. Established Lessons Learned and Best Practices

**TABLE 2. Contracting Capabilities Maturity Model (Sorsa 2009 and Salmi-Tolonen 2009).**

KPA	Ad hoc	Repeatable	Functional	Integrated	Optimized
CON-TENTS	All contracts drafted ad hoc	Offer - acceptance and standardized templates for repeated transactions	Standardized, modular templates; modules selected according to project type	Contract structure sensitive to project flexibility	Contract contents are developed proactively and tailored according to customer needs
	Sporadic use of guidelines or GTCs	Guidelines for drafting complex or high visibility contracts	Some GTCs in use	Contract templates, models and GTCs in use for all contracts	Contracts designed with full understanding of their contribution to mutual business needs
	Reactive approach to legal risks	Observes legal norms and self-regulation rules	Requirements of corporate social responsibility are recognized and reflected in contract contents	CSR goals are explicitly expressed	Advance proactive measures of CSR
PRO-CESS	No alignment between productizing, sales, business and contracting	While a proactive approach may be evolving, most of the activity still reactive	Process plan in use	CSR processes fully integrated with other organizational processes e.g. cost mgt, schedule mgt.	CRM processes streamline initiatives as part of its continuous process improvement program
	Focus on result metrics only	Some level of tracking and reporting initiated	Processes are measured, metrics in use for proactive monitoring	Both results and process metrics are in place to track performance	Systematic use of performance metrics to measure the quality and evaluate the efficiency of the process
	Transaction based	Based on operative cooperation	Based on tactical cooperation	Based on strategic cooperation	Based on shared value generation
RELATIONAL	Aims according to own specs	Aims at cost effectiveness	Aims at strategic advantage for all parties	Aims at value generation for all parties throughout the business	Contract viewed as manuscript for creating value for all parties; exchange of info on processes and practices open and free
	Written contracts rare	Roles and products well-documented in contract	Interaction in addition to well-documented roles	Beginnings of a collaborative relationship	An in-built incentive system for performance excellence
	Parties unaware of existing commitments or whether execution is in line with them	Parties aware of roles and commitments and try to comply with them	Parties understand commitments and comply in collaboration	Consequences of operationalized	Contingency management
ORGANIZATIONAL	Conflicts are resolved ad hoc	Need for conflict mgt is acknowledged but not in use	Documentation on contingency handling	Proactive approach to contingency management	Contingency management an integral part of the management
	No company specific contract tools	Dedicated team formed to develop contract models, processes, procedures, tools systems and metrics	Contracting is fully established, institutionalized, and mandated throughout the organization	view to rationalize and align policies, procedures and processes across the business	Policies, procedures and processes are optimized and comparable to ISO or other standards
	Managers and contract personnel not held accountable for adhering to any contracting processes or standards	Contract managers hired or assigned to lead contracting and business organization to drive change	Senior management provides guidance direction and approval of key contracting strategy, decisions and tools	In addition to representatives from other organizational offices, other contracting parties are integral members of contract teams	Established lessons learned and best practices programs to improve contracting contents and process standards



Programmes are in place to improve contracting contents, processes and the use of relational capabilities.

Routinization (Söderlund et al. 2007, 18) means institutionalizing what is known within the project or company; securing a memory function within the management team is an important learning mode in maturity model. For moving from the *ad hoc* level towards the higher levels of the maturity scale, the documentation of practices and the culture of continuous learning are needed.

## 6.5 CONCLUSIONS

By identifying the dimensions of contracting capabilities and operationalizing them, individual contracting capabilities – a so-far undiscovered capability – can be translated into an organizational capability. Consequently, by carrying out this transposition successfully, a company can learn to avoid less successful practices and repeat its successes. Individuals achieve capabilities through learning, practising, observing the results and improving their performance on the basis of experience. An organization achieves capabilities in a similar manner: through learning, implementing practices, observing and measuring the results, and improving. Therefore, the organization needs tools, methods and processes to retrieve and generate knowledge in order to train its employees to successfully manage and deliver contracts and projects. In order to do this, a maturity model was created to be implemented into organizations.

On the bases of the pilot interviews, it seems that the suggested maturity levels and their attributes are applicable to the assessing of IT sector projects' contracting capabilities. Typically, developments of new business models, such as the new agile methods, seem to be a few steps ahead of the contracting capabilities (Siiskonen 2009). This confirms our findings drawn in the contracting capabilities project that contracting should be understood as a wider concept starting from the planning and productizing involving experts from all areas of the project: technical, marketing, sales, management, and legal. (Sorsa and Salmi-Tolonen 2009)

Contracting capabilities have not been fully exploited thus far. By identifying the dimensions of this capability by assigning attributes to it in order to operationalize the key performance areas of the maturity model, managers will be able to employ it as a management tool. This maturity model also

makes contracting a measurable entity. By formalizing contracting, a company improves its cost effectiveness. Furthermore, the use of the maturity model in the contracting process will help avoid superfluous costs in doing business. Contracting capabilities play an essential role in service industries and in project business.

## 7 SUMMARY

The networking innovation society addresses the potential of humans to generate new knowledge and ideas, to be creative and to stimulate new products and services. This section of proactive contracting aimed at generating new understanding of contracting as a management tool for business. The notion contracting indicates that we are talking about a wider concept than that of contract law or contract as a document. Contracting has been analyzed here from different relational perspectives and from contract management perspective.

Contracts are relied on to form and govern transactions, to communicate with stakeholders, to manage opportunity and risk, and to execute key business strategies concerning, for instance, innovation or corporate social responsibility. Other tools beside contracts are provided by a large array of different self and private regulation standards, which are an elementary part of contractual relationships either directly as part of a contract terms or on the background as a guiding principle in the broader relational context. Their role is accentuated in the value chain management.

The role of contract management has become a necessity in many companies as the out-sourcing, networking and service business is based on the use of contracts as a governance tool. Contract management needs to be developed and assessed continuously like other business processes. Contract management maturity model was developed in order to improve the contracting capabilities of the companies. Ideally when implemented and used correctly the maturity model provides a self-assessing and self-correcting continuous point of reference for a company's contracting capabilities.

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# **IV** PROACTIVE MANAGEMENT AND BUSINESS ETHICS





# I INTRODUCTION

*Amparo Camacho & Enrique García*

The current economic environment is turbulent (complex, dynamic, diverse and hostile, as defined by Ansoff, 1988) and increasingly globalised. In this context, companies need to be prepared to compete on a global scale. Business competitiveness can no longer be based on aspects that have worked traditionally in the past; rather it should focus on creating value as a source of sustainable competitive advantage which promotes development and, in the worst cases, permits survival.

At the same time, business strategy should include ethics as a differentiating element which, apart from differentiation, improves business performance and helps meet the expectations of all those participating in the company's value chain. In traditional legal education lawyers have been trained to respond to problems, and usually companies involve lawyers in their processes when problems or conflicts arise.

Management has to understand the strategic value of legal knowledge. This “legal astuteness” as described in Section II, Part II of this handbook involves the integration of Legal knowledge as a source of competitive advantage. Law and Regulations as well as Proactive Contracting can contribute to the value of businesses and the business environment.

However, as most elements in the business context and the society in general have a legal component, the contribution of lawyers to business exploration processes aimed at seeking opportunity spaces and value creation is invaluable. For this reason, providing future legal professionals with the necessary background knowledge and skills to become active members in key business processes becomes essential.

Proactiveness as an organizational attitude can be described as a permanent identification of opportunities to which an adequate response is given. Therefore, the identification of opportunity spaces and the definition of strategies to respond to them should be developed in organizations as a key

process, which can be learnt and systematised and where lawyers, the same as any other company member, should play a key role.

This chapter module focuses on these two key elements of business management:

- Strategic Management
- Innovation (or Exploration) Management.

Throughout the course, participants will become familiar with business strategy, analysis and strategy formulation as well as exploration processes, innovation capability and opportunity management.

At the same time, the module will contribute to the integration of the ethical perspective when taking strategic decisions or defining opportunity spaces, and it will help the students become familiar with CSR indicators established by the Global Reporting Initiative, which can be used to carry out preliminary assessment of business projects and ventures.

## 2 PROACTIVE STRATEGIC MANAGEMENT

*Amparo Camacho & Enrique García*

### 2.1 INTRODUCTION TO PROACTIVE STRATEGIC MANAGEMENT

As mentioned before in the book, almost all fields of management have been studied extensively from a strategic perspective, besides law. The reason is self-evident: with few exceptions, lawyers (as well as most professionals from non-business related fields) are not trained in strategy, and managers or strategy scholars have no or little background in law.<sup>128</sup> Business strategy is ultimately implemented by means of various legal instruments or instruments with a considerable legal component, such as contracts, financial regulations etc. However, legal professionals are usually involved at the end of the strategy design process, when the main decisions have already been taken.

Providing future lawyers with basic key knowledge and skills about strategic management, together with promoting strategic attitude, will enable legal professionals become active participants in strategic processes since their very beginning and, most importantly, to be proactive in contributing to them from a legal perspective. Also providing future managers with basic legal knowledge and teaching them how to cooperate with the legal discipline, together with a proactive attitude towards legal knowledge, enable managers to improve the business.

Corporations are, without a doubt, increasingly complex organizations that face social and economic environments that are more dynamic, complex and uncertain than ever before. That is why the ways in which they are managed must also adapt to the current setting to help companies to withstand constant change, giving them the capacity to anticipate these changes through decisions that help it survive and develop in this turbulent and competitive environment.

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128 Robert C. Bird, *Pathways of Legal Strategy*, 14 *Stan. J. L. Bus. & Fin.* 1, 3–4 (2008).

Management models that we would now consider “classic” (from the 1950s to the mid-1960s) addressed the needs of a stable corporate environment, and strategic mechanisms were based on controlling results and quantitative variables which ensured the good running of the company.

Beginning in the mid-1960s and as a result of the increasingly unstable environments faced by corporations, the concept of strategy was incorporated into the management field. With conventional management styles proving to be ineffective in helping organizations adjust to ever-more hostile settings, there arose a need for solutions that would help the economic organization survive, or increase its efficiency. Meeting these needs was the aim of a new concept for the time known as corporate strategy; this was attained by way of the so-called strategic management of the corporation.

*Corporate strategy is defined by the company's general objectives and its fundamental courses of action in keeping with its available and potential means, in order to achieve its optimal insertion into the social and economic spheres.*  
(Menguzzato and Renau, 1991)

The aim of this strategy is to address the company's on-going need to adapt to changes arising within its environment. The significance and speed of these changes are aspects that define the strategic scenario in which the company acts and therefore the mechanisms it uses in its management.

### **2.1.1 Strategic attitude: concept, rationale and characteristics**

Faced with this environment it becomes important for companies to adopt an attitude that will help it to respond to changing settings and allow it to systematically collect relevant information from the spheres in which it carries out its business activities.

One could say that companies are facing a “strategic problem” as per Ansoff's traditional definition (1965), which can only be solved by way of a certain attitude from management which is extended throughout the entire organization, taking into account its internal complexity (Hofer and Schendel, 1978) and the problems specific to it (Ansoff 1980). This organizational culture demands a set of specific characteristics of the managing body, such as the capacity to anticipate trends and self-criticism along with a certain predisposition toward change (dynamic capability) and the ability to lead the company by constant adaptation to conditions existing in a constantly-changing reality (Menguzzato and Renau, 1991).

### Concept and characteristics

The main characteristics which determine a strategic attitude – those which any company should adopt to meet changes arising in its environment – are described below:

- This attitude should be *extrovert* in the sense that the company needs to be conscious of the ever-changing context around it, aware of the numerous environmental aspects that may have an effect on it, and of the idea that it will need to adapt to outside changes.
- It should also be *proactive* and show *resolve*; management must be convinced that the future of the company can be shaped through the development or implementation of specific actions on the part of the company itself.
- It should also be able to *anticipate change*. It must be able to foresee potential changes in order to ensure a greater capacity to react to these changes. Changes in law and public and private regulation are part of the anticipation. A subject where the legal discipline can/should contribute, involving all members in the company's management structure so as to monitor these changes and actively contribute to the process.
- It should *accept* and not fear *change*, and understand that change can lead to good things that will benefit the company.
- It must be a *critical* attitude, questioning everything that happens within the organization, with a clear objective: to improve.

Company management must adopt a strategic attitude in order to enact a strategy that is in keeping with the requirements of the social and economic context in which the company carries out its business activities.

### 2.1.2 The strategic management process

This process is driven by company management, its primordial objective being to develop a strategy and put it into practice. This process is characterised by:

- *Uncertainty* about the context, competitor behaviour and customer preferences.
- *Complexity* which is derived from the numerous ways of perceiving its environment and said environment's interaction with the company.

- *Organizational conflicts* arising between decision-makers and those affected by said decisions.

Strategic management sees to the decisions taken to formulate and implement strategies, which involves the mobilisation of company resources to achieve the established global objectives.

We can view the global strategic management process as encompassing two broad components:

- a) Formulation of strategies.
- b) Implementation and monitoring of strategies.

There is a logical order in the temporal development of the process, but also necessary is the process of feedback based on information obtained throughout.

Strategic analysis is the process which helps to determine the set of threats and opportunities existing in the company's context as well as the strengths and weaknesses of the organization. It gives management a diagnosis and an assessment of the situation which enables it to formulate strategies once the company's objectives, aims, goals and missions have been defined. Jointly determining the strategic space that will define the company's activities as well as the axes upon which said strategy will be constructed, strategic analysis consists of three components: defining general aims and missions of the company, external analysis and internal analysis.

### **a) Formulating company strategy**

The formulation phase of the strategy mainly involves how the strategic planning will be defined, whether it will follow the strategic or classic model, broadening the analytical scope to include hard variables (technical and financial) as well as soft variables (social, political and cultural).

This phase in the formulation of strategy can in turn be divided into the following sub-phases: *the intelligence, conception and selection phases*.

*The intelligence phase* is the moment when the strategic problem is identified, the problem being understood as being the difference between what the company wants in terms of its aspirations and its changing context, and the potential situation in the absence of a new strategy. This phase can be broken

down into three broad stages: strategic diagnosis, definition of the company's general objectives, and the identification and analysis of this strategic gap.

Within strategic diagnosis there are two parallel analyses that jointly assess the current and potential status of the company in regard to its environment.

- *External analysis* examines the impact of so-called strategic factors within both the immediate and general environment, and their future development in order to detect potential threats and opportunities for the company. An analysis of the competitive context is usually based on a sectorial analysis and its competitive forces. Studying the future trends within the environment requires both foresight and prospective vision.
- *Internal analysis* identifies and assesses current strategy and the position of the company with respect to its competition, evaluating company resources and skills with an aim to understand both the strengths it must strive to exploit within the new strategy and the weaknesses which it needs to eliminate or remedy. Analysis of resources and skills, functional analysis and value chain analysis are all useful tools in internal analysis, as we shall see in later sections. We should also mention strategic analytical models such as business matrices analysis, which provides an assessment of the company's competitive position and its opportunities for improvement, both at the individual business activity level and the business as a whole.

This double analysis gives us information on what a company is, what it does and what it can do; once this analysis is carried out we can determine what the company would like to do.

During the phase in which the general objectives are defined, we look at general aims in terms of the company's mission, the characteristics and demands of the future corporate environment as well as the company's potential capabilities. At this point there appears a group of people with the power to influence decisions taken within a company, with their own objectives and aspirations that behave according to a particular code of values.

During the phase in which the strategic gap is defined, we try to determine the difference between what is being done and what can be done; what we want to do helps us to identify what needs to be done. To achieve these aims the gap between established general objectives and the results the company plans to obtain with their current strategy is examined, bearing in mind its

existing capabilities and its possible evolution within the contexts identified in the various scenarios. Strategic difficulties arise when decisions, actions and deployment of capabilities of the company are not consistent with the requirements and demands of the context and/or the company's aspirations.

Gap analysis concludes the intelligence phase. The problem has been taken into consideration and the company need only to define possible solutions and select the one that best suits the company's objectives.

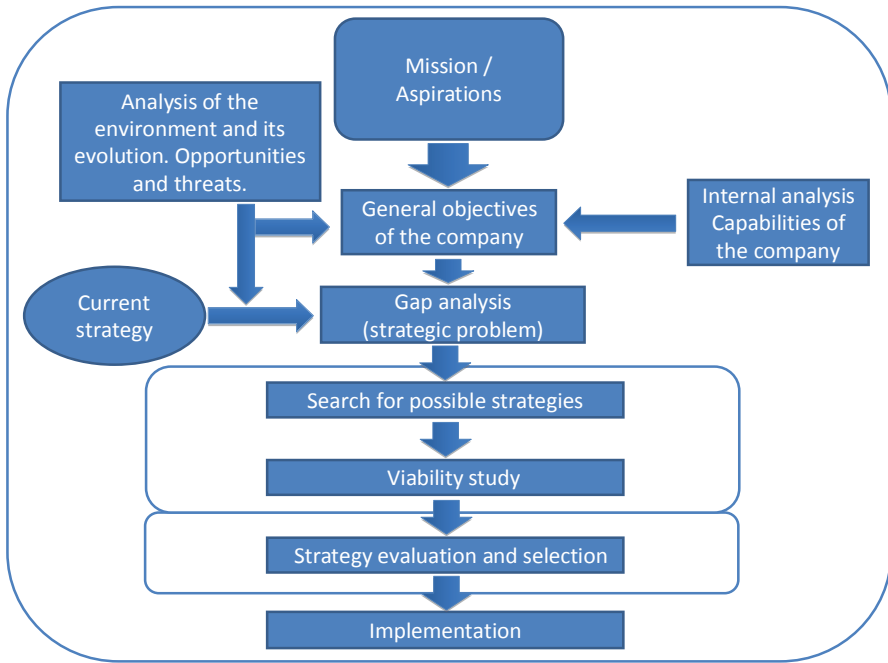
*In the conception and selection phases* we try to find strategic alternatives that will close the strategic gap identified in the previous stage.

If the demands, company capabilities and aspirations are mutually compatible, the solution to the problem may only involve a slight readjustment to an existing strategy. Yet the existence of a strategic problem may require major changes to the strategy or even the design of a new strategy that defines strategic approaches as well as the actions needed to fulfil them in general, business and functional terms.

It is important to propose as many strategic solutions as possible according to the information available. In addition, a feasibility study will allow companies to examine the risks involved in proposed strategies and prevent them from becoming reality or hindering the desired effects and results owing to a company's shortcomings in terms of certain resources, skills or new conditions that arise in the competitive or general environment.

Once various feasible solutions have been designed, the selection process begins. This stage requires an assessment of each option, which is assigned a rating based on its value or usefulness according to the extent to which it contributes to established objectives, optimally uses the resources and skills of the company and the opportunities present in its environment, and/or its capacity to reduce or eliminate company weaknesses and risks associated with its environment. Given the characteristics of our turbulent business environment it should be noted that the option chosen will necessarily involve a set of contingent strategies that are in keeping with the fundamental elements of the global strategy and the various scenarios defined in the prospective analysis of the context. The process by which strategy is formulated can thusly be represented as follows.





**FIGURE 1.** *Strategic Management Process.*

It is important to note that this process is not a linear process per se, but an iterative process which involves possible backtracking to previous steps. This iterative returning to prior stages can be explained by the fact that, like all decision-making processes, the conditions of uncertainty and incomplete information make it necessary to proceed by way of trial and error in order to find a solution. But this is also true, because the process of formulating strategies is not something which occurs once in a while. There is a constant interaction between the strategies designed and chosen by the company and the turbulent environment in which it operates; this ever-changing environment too is influenced by said strategies, with company capabilities also changing both under the pressure of the chosen strategy and outside its realm. The company's mission may also be affected by new strategies which in the long term could affect the development of the organizational culture and value system which can equally be influenced by radical changes in the company's environment and/or internal setting.

In addition to formulating the strategy, the company should also be provided with the structural and instrumental conditions needed for its implementation; in many instances the absence of studies associated to implementation can lead to strategic failures or less-than-desired results. (See Amazon's "1-CLICK" selling in Part III, 2.1 in this handbook).

## **b) Strategy implementation and monitoring**

The aim of the second phase of the process is to put the chosen strategy into practice and ensure it is carried out effectively, both in regard to execution and validity. This stage is broken down into three broad areas.

**Planning:** To put any strategy into practice, we need to take the strategic approaches defined in the formulation phase and translate them into strategic and tactic plans, programmes and budgets detailing the specific actions to be taken in the various areas of the company at different organizational levels, increasing the level of detail as we approach the operative level. Planning (defining the steps that will put the formulated strategy into operation) constitutes one of the three fundamental tasks of this phase.

**Monitoring:** The second part of this phase involves monitoring activities. This function is based on feedback and allows us to designate corrective actions based on the information provided by analysis of differences observed between obtained results and expected results. But not only is it necessary to conduct subsequent analysis, we also need to carry out monitoring activities before implementation that allow us to undertake actions that are more preventative than corrective.

**Organization:** Planning is not the only way to ensure satisfactory execution of any strategy. We also need to assign the various tasks and associated responsibilities to members of the organization, coordinate and integrate action, establish how authority will be deployed and the communication channels through which information should travel, in terms of quantity and quality, as required. The members of the organization are the people who will put the plans into operation and execute them; therefore the way in which they are guided, trained and motivated, as well as the way the company's existing culture will be orientated, will also play a decisive role in ensuring the success of the strategy.

The existence of information and communication systems that will help address the analytical needs of the first phase on the one hand and the

requirements that arise in the planning, monitoring and organization phases on the other is another key aspect that, along with the organizational structure and culture in addition to management and leadership styles, constitutes the “superstructure” of Strategic Management. The core of the implementation process is represented by the management’s capabilities in terms of leadership and corporate culture, which influence the way in which the strategies are transformed into action.

To summarise, we could say that the mission of Strategic Management is to give the company a competitive advantage, and to do so, it must identify a strategy that is consistent with the structure of the sector and organise the company to enable it to execute said strategy. Therefore, success depends on a two-way fit: that between the sector structure and the strategy, and that existing between the strategy and the internal structure of the company. Incorporating the legal discipline in the strategy making process can deliver value. In the analysis phase, legal knowledge and opportunities constraints are valuable. Even more in the implementation phase legal knowledge is required.

### 2.1.3 Strategy: concept, components and levels

#### a) Concept

The strategy concept appears in the economic and academic fields with game theory, which was posited by Von Neumann and Morgenstern in 1944. In the management field, it was introduced via the works of Chandler (1962), Andrews (1962) and Ansoff (1976). The concept of strategy applied to the field of business arose in the 1960s, but it has evolved in parallel to the increasing sophistication of management systems themselves, along with changes in the internal and external problems that they have faced.

There are two general perspectives we can use to describe the concept of strategy:

- Broad approach: the concept includes the definition of objectives, aims and goals sought by the company.
- Restricted approach: strategies are understood as being the means to achieve previously established objectives.

Key dimensions in the concept of strategy are as follows:

1. It represents the company's response to the environment in which it operates.
2. It is a template for consistent, unified and integrated decision-taking.
3. It determines the company's purpose in terms of long-term objectives, action programmes and priorities in resource allocation.
4. It helps the company choose the business activities it participates in or will participate in.
5. It tries to achieve a sustainable competitive advantage for each business activity.
6. It encompasses all hierarchical levels (corporate, business and functional).
7. It defines the nature of economic and non-economic contributions to organizations related to the company's business activities.

Strategies should provide a set of standards, rules and criteria to be used in future decisions taken by the company; it therefore serves to orientate. The orientational role of a strategy can be defined in terms of components and levels in turn.

## **b) Components**

Although many authors have debated widely as to what elements make up any strategy, there are four components which must always figure in a strategy and which the company should take into account when it defines the business strategies that will enable it to respond to its environment.

- The scope or field of activity. This is needed in order to demarcate the company's field of action, that is, the breadth and characteristics of those "productive" relationships it holds with its social and economic environment. Here we are specifying the type of business the company intends to participate in.

When referring to strategy we should point out that it becomes necessary to define each line of business the company intends to participate in, in terms of products and markets, or product-market relationship. The product, in turn, is defined according to two variables: the needs said product covers and the technology used to cover said need. This is why the company must identify each and every one of its lines of business – each one has its own competition, characteristics, and they may be directed to different markets and will therefore require different strategies.

Therefore, the sphere in which a company plans to conduct its business will be defined by its portfolio of business activities, made up of the combination of the various needs-market-technology aspects of concern to the company.

- Distinctive capabilities. This refers to the resources (physical, technical, financial and human, among others) as well as the skills (technological, organizational, management, among others) both existing and potential, and which are owned by the company or part of its expertise. These skills, also known as competences, are those which enable the company to obtain certain results using its material and financial assets. These are acquired over time, originating in its employee profile as the result of recruitment, training and personnel management; its methods and technology; its organization and management as well as its value system.

All this is what distinguishes one company from the next. Those skills which cannot be generalised across companies are skills that differentiate. Companies must try to determine the level and model that should be used to develop and allocate these capabilities (resources and skills). Their wise use will help to achieve an organization's objectives, giving the company a competitive advantage in the market it has chosen to carry out its business activities. These distinctive capabilities can be found in any field or area within the organization including the company's legal department or legal support service. With support from legal professionals, the company should use Legal Knowledge as a resource that brings differentiation (e.g. in banking, insurance processes and interaction with energy enterprises) and on something which to base its strategy in the search for competitive advantage.

- Competitive advantages. This refers to the characteristics that the company can and must develop to obtain and/or reinforce its advantageous position vis-à-vis its competitors. In a competitive environment, companies should not only be able to carry out its particular set of business activities, but it should also try to do so in the best way possible, outdoing its competitors. This privileged potential may also result in the acquisition of key resources, e.g. access to raw materials, technologically superior equipment, patents, specialised staff, exceptionally motivating corporate culture, an information system that is advanced and especially adapted to company needs, among others. The contribution of Law in the value chain and the creation of competitive advantage are dealt with in detail in Part III, 3.1 in this handbook.

- Synergies. This component refers to the extent to which a company seeks out positive synergistic effects that arise from the balance between the company's field of activity, distinctive skills and competitive advantages. It is important to look for positive complementary aspects among these three elements of strategies to obtain a greater degree of efficacy. This means that the company has to determine exactly what it must do to integrate all its areas in such a way that joint effort by all parties involved is greater than the sum of its individual actions.

### c) Strategic levels

In view of the current corporate context and to enhance the function of strategic management we may need to apply hierarchical levels to strategy. If we take the example of a company which carries out a single activity in a simple and stable context, we would be referring to a single strategic level in which the search for appropriate capabilities, competitive advantages and synergies would merge with strategic concerns only at the functional level. Now if that context were turbulent as the one we are experiencing today, we need to identify two strategic levels since the development of the right resources and skills, and the search for competitive advantage and synergies, becomes more important due to the adverse and unstable conditions present in our context. We must also be able to frame and coordinate essential functional strategies within the strategy of the business activity.

Moreover, in the case of companies that diversify (those which carry out a variety of activities or operate various businesses), in addition to the levels already mentioned, we should add a higher level which encompasses the various business strategies and considers the problem from a perspective that includes the right combination of the different activities.

Companies wishing to develop the right strategies must define the following three strategic levels as follows:

- Global strategy or corporate strategy is also known as company strategy or master strategy. This refers to the general plan of management action for a diversified company. At this level the company is considered in relation to its context, determining which business activities it will participate in and the most appropriate combination of activities. Here more weight is given to the first and second components, as the issue involves demarcating the company's field of activity and allocating capabilities among the

various businesses that comprise the context. The fourth component is understood as a search for the synergistic effect resulting from appropriate integration and the degree to which the various activities complement each other.

- Business strategy represents the second level and becomes necessary in companies that carry out many activities. The aim here is to determine how each business will compete within the given context. This level affects distinctive capabilities and the competitive advantage, which are components that should be present at this strategic level in order to help determine competition paradigms for each activity. For the fourth component, emphasis is placed on synergies that are produced by integrating the different functional areas successfully within each activity.
- Functional strategy is the third strategic level and the one that involves operative concerns. At this level the objective is to define how to use and apply resources and skills within each functional area of each activity or strategic unit with an aim to maximise productivity of said resources. The second and fourth components are key here as the latter component represents the synergistic effect derived from the appropriate coordination and integration of the various policies and actions developed within each functional area.

In addition to activating action at a functional level, it is important that functional strategies help to achieve company objectives and support corporate strategy. These act as hinges between global strategy and planning. Basic functions of company activity are those involving production, marketing, investment and financing, personnel or human resources as well as research and development, among others.

## 2.2 THE INTELLIGENCE PHASE

### 2.2.1 Scan and analysis of the overall and competitive environment of the firm

*The firm's overall environment – strategic factors*

The firm's environment is made up of a set of elements which exert pressure on the firm. Elements or factors within the environment have an impact on all companies and organizations participating in a given socio-economic system

homogeneously, and in particular on an industry, sector or region, inasmuch as they provide the general framework of action for these firms and organizations – each firm perceiving the impact differently as determined by its individual characteristics. We could say that the impact of a given phenomenon occurring in the environment can either be positive or negative, causing a greater or lesser impact to each firm, representing either a threat or an opportunity.

The overall environment is that which comprises a set of factors that affect all firms, and is considered a threat or opportunity depending on the nature of the impact as perceived by the company. The organization must be able to identify threats in order to define a defensive position as well as opportunities to position itself in such a way as to take advantage of any benefits they have to offer.

The elements that should be taken into consideration are those known as the environment's strategic factors. These will have a significant impact on the firm's business activities and/or its results. They can be grouped together as follows:

General economic factors. They represent the main indicators of the economic system in which the firm acts: the existing type of economic system, whether it is in expansion or recession; trends in GDP and income which affect consumption; inflation trends and levels, as these usually place downward pressure on company margins and consumer purchasing power as well as employment rates – unemployment also representing a cost to firms; balance of trade, with deficits implying a vicious circle that is generally detrimental to demand costs and availability of raw materials and energy; monetary policy and its implications in terms of interest rate levels, credit limits, exchange rates and economic policies, not only with respect to the firms themselves but also with respect to the rate of consumption.

Legal and political factors. The existing political system, existing political party system, system of government, ideology of the parties in power and system of trade unions are all essential aspects in the regulatory activities that determine legal provisions defining the functioning of the country, creating a situation which is more or less conducive to the development of business. Also important are subsidy and incentive systems, regulatory and foreign trade systems, the role of government corporations as well as regulations and laws that govern firms.

Sociological and cultural factors. This group of factors includes aspects such as the way society is organised and the general social climate and demographic variables such as population growth rate, age distribution and mobility.



Education-related variables include the degree of illiteracy among a population as well as the level of general and specific training and education. Also included are value systems and beliefs, work ethic, attitude towards authority and interpersonal relations, among others.

Technological factors. This group of factors is related to how science and technology is used with respect to the field of production processes and/or new products, management methods and information systems. These factors now exert a strong influence on economic activity in general, the structure of competition of any given sector, and competitive positions of companies as well as the organizational structure of companies, human resources and communication.

### *The competitive environment – basic competition forces*

The competitive environment of a firm consists of a set of agents and factors that exert a direct influence on the results of said company and its competitors. It is therefore essential to the company; knowledge of this context and its development are key to the design of strategy.

Industrial economics is the field which has concerned itself with the study of the competitive environment and its components – buyers, sellers, barriers to entry and exit, product differentiation etc. However after Porter's contributions to the field (1984), these elements began to be studied as a whole in addition to their associated implications for company strategy, something which had not been done before.

Porter grouped these components of the competitive environment or competitive forces into five groups. These five competitive forces and combinations thereof influence results to be obtained in a competitive environment; by understanding them we can characterise the competitive environment or sector, determine the type of competitive environment we want to participate in as well as identify those which are unsuitable, that is, the strategies we need to adopt. Below is a list of variables that should be borne in mind in this analysis.

#### **a) Potential competitors: Initial barriers**

The decision taken by a firm to enter a sector will depend on a set of variables that create so-called entry barriers. This includes a set of factors that provide

established companies with advantages over potential candidates; entering a given sector involves certain costs that will put said company at a disadvantage with respect to established firms and therefore represent a barrier to firms wishing to enter. Entry barriers are attributable to the following factors:

### 1. Economies of scale

This is the fall in average cost of production as quantity produced increases over a given period of time. It is important to note that not all products give rise to economies of scale. Moreover, the underlying reasons for economies of scale are diverse due to high fixed costs distributed among a greater number of units as well as the use of certain technologies or the input purchase process. Economies of scale act as an entry barrier, because companies wishing to enter a given sector will have to choose one of two very difficult options:

- Make a small initial investment, which results in a small production capacity and low competitiveness.
- Make a large investment to allow for high production capacity. Costs are similar to those incurred by established competitors, which represents a high risk for companies wanting to enter sector.

### 2. Product differentiation

This measures the extent to which buyers prefer one product offered by a given company in the sector over another. This differentiation may be attributable to real causes such as differences in quality, price, components, aftersales services or intangible factors that create differentiation based on consumer's perception of the product, such as company image or prestige. These latter differences are not attributable to tangible aspects.

Whatever its origin, product differentiation acts as an entry barrier as it provides benefits to existing companies with respect to potential companies. Buyers prefer products offered by established firms. Thus, companies wanting to enter a given sector must make significant investments to break down existing loyalty. In general, when a product is prone to differentiation, the entry of new competitors is more difficult. The lesser the degree of differentiation the more likely it will be for buyers to change companies (due to lesser degree of loyalty towards a brand or product) which in turn generates more competition.

### 3. Advantages in production and distribution

There is a set of factors that give companies the advantage in production and/or distribution, and which usually translate into cost advantages. These advantages usually come from ownership of technology (patent-protected) used in production processes that increase productivity and lower costs or ownership of sources of raw materials. The latter represents a great advantage for companies, not only in terms of production but also in obtaining different products.

Companies will also have an advantage when they have privileged access to capital needed for acquisition of assets; this can reduce costs and enable expansion as well as provide other benefits. Owning its own distribution system will also favour greater diffusion of products and a greater sales/distribution cost ratio.

### 4. Learning and experience effects

This refers to the decrease in time taken to execute a given activity the more times it is executed, where this reduction in time occurs at a constant rate. This effect allows some companies to obtain an advantage in costs. This implies that new competitors wishing to enter the sector will incur greater costs that impede or limit their access to the market.

### 5. Government policies

The government can also limit or impede entry of certain industries via licenses, minimum capital requirements and limits to access to raw materials among others. Similarly, entry by foreign companies may be limited or impeded by way of tariff barriers. Governments can also grant subsidies to established companies, positioning potential competitors at a disadvantage in terms of costs.

#### **b) Rivalry between competitors**

The degree of rivalry among competitors, that is, the intensity of competition, could affect the appeal of a given sector. Fierce competition among companies within a sector, wherever there is a large number of companies offering poorly differentiated products, results in low prices and a decrease in profits making the sector unappealing. In contrast, a sector with few companies and highly differentiated products would give rise to higher prices and profits creating an attractive sector.

The degree of rivalry among competitors depends on degree of saturation, product differentiation, exit barriers and mobility barriers.

- **Degree of saturation:** The degree of saturation results from the number and distribution of competing company sizes. Saturation varies when there is a change in the number of companies, average company size (this refers to sales figures, number of employees, etc.) or their relative distribution (lesser or greater differences in size or rather a larger or smaller dispersion). If the number of competitors is high, there will be a tendency for greater competitive activity as companies perceive their movements as going unnoticed. If competition is balanced, competition wars may arise. In both cases, there will be a tendency to increase competition. Rate of growth in the sector will also influence the degree of rivalry. If growth is high, rivalry will be moderate whereas low growth will give rise to greater rivalry.
- **Product differentiation:** This factor affects the intensity of competition among companies already established within a sector or market, which acts as a potential entry barrier. As product differentiation increases or decreases across competitors, there is an associated increase or decrease in loyalty among buyers towards specific products which causes greater or lesser stability in demand and a greater or lesser degree of competition.
- **Exit barriers (industrial sector):** Exit barriers refer to a set of situations that impede or hinder exit from a given sector by a company (even incurring losses as this action involves great costs). The causes of exit barriers are attributable to different situations. The main causes are as follows:
  - Specialised, long-term fixed assets. When a company owns specialised fixed assets and is interested in leaving a sector, it has to try to sell said assets to other suitable companies. Because assets are specialised, the number of ideal buyers decreases resulting in a decrease of the selling value. The fact that these assets are also long-term aggravates the situation; more time is required to sell them, which involves their depreciation. The company remains in the sector throughout this time.
  - High fixed exit costs. When a company decides to leave a sector it may face very high fixed costs which may make said movement unfeasible or lead to an associated sale price that is quite reduced. These costs are incurred in staff reduction and cancellation of contracts with suppliers, distributors etc.

- Legal barriers. There are legal provisions or governmental positions which make closing difficult for certain companies, especially those which involve loss of jobs or activities in the public interest.
- Psychological barriers. These are attributable to the attitude of company owners and/or managers who try to impede exit from a given sector or closure of the company itself (owing to personal fears for their future or other emotional reasons in the case of managers).

### **c) Substitute products**

The existence of these products give rise to greater competition among companies of the sector. The pressure they exert are largely determined by the degree of product differentiation of existing products, as this influences customer's acceptance of substitutes via the loyalty they feel towards certain products. Still, there are substitute products whose costs, qualities and performance are superior to those already in existence, which creates greater demand in detriment to traditional products.

### **d) Customer bargaining power**

Profitability in any sector is based on the added value generated within said sector: if added value is low, obtaining satisfactory profits is more difficult. If we consider added value of a sector to be a link in a chain connecting supplier to end-consumer, the fraction of the total added value that can be appropriated by a company is, to a large extent, determined by the negotiating power they have with respect to suppliers and customers.

For the same added value, the sector will obtain a greater portion if it can attain higher income from its customers and reduce the amount given over to suppliers (favourable prices for suppliers and customers negatively affect profitability and vice versa). The power of customer or buyer negotiation will depend on the saturation within the sector. Therefore a single customer will give rise to a monopsony in which bargaining power will lie in the hands of said customer.

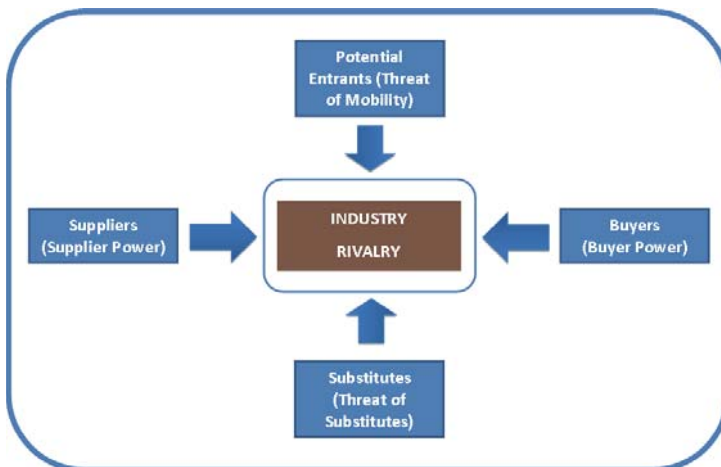
Product differentiation will also play an influential role, and customer bargaining power will increase as the degree of product differentiation decreases. Similarly, bargaining power will increase if there is a high potential for backwards vertical integration for customers as they can use it as leverage in

a bargaining scenario. If customer profitability is reduced but still significant (due to its purchases), its bargaining power also increases in order to achieve a reduction of purchase prices to increase its margins and profitability in turn.

### e) Supplier bargaining power

The factors which influence supplier bargaining power are similar to that of customers as their negotiation positions are symmetrical. The greater the saturation (the limit here being a monopoly), the greater the power of negotiation. The greater the product differentiation, the greater the bargaining power. Forward vertical integration constitutes a significant point of negotiation for a supplier as they can use this as an argument – customer roles can be carried out by supplier by way of said integration. The existence of substitute products can reduce supplier bargaining power with respect to existing products in benefit of the company offering the substitute product.

To conclude, we can state that the greater the bargaining power of suppliers and customers who impose their own terms and conditions, the lower the sector's appeal for companies. In contrast, the lower the bargaining power of suppliers and customers, the more attractive the sector will seem as companies within said industrial sector will enjoy the best conditions.



**FIGURE 2.** Michael Porter's Five Forces Model. (Source: "The Five Competitive Forces that Shape Strategy". Harvard Business Review.)

## 2.2.2 Environment evolution: forecasting and prospecting

The factors that make up the firm's environment exhibit a series of interrelationships and their combined behaviour will result in various types of business activity contexts. Knowing what type of environment will be host to the firm's activities is useful in its analysis.

The type of environment and the way it behaves will determine the attitude the company adopts within said setting. Although it is a difficult task given the large number of variables under consideration, we are going to try to identify the various types of environments below. With the use of contributions of Mintberg (1984) and Bueno (1996) we can summarise the various environment types using four basic characteristics:

- **Stability.** Depending on whether the factors which make up the environment remain stable or not, we can designate the environment as being stable or dynamic. This factor is also influenced by degree, depth, speed and degree of unpredictability.
- **Complexity.** This refers to the complexity shown by factors themselves and changes they exhibit. Their degree of comprehensibility will determine whether simple or complex knowledge is required to analyse said factors and this will determine whether the environment is simple or complex.
- **Diversity.** An environment may comprise many variables or just a few. The extent to which they differ from one another will determine the diversity of the environment; here environments can be considered integrated or diverse.
- **Hostility.** An environment can be seen as being hostile or favourable to a given firm depending on the speed and impact of said environment and the capacity of said firm to respond.

By taking the characteristics listed above and integrating them with that proposed by Emery and Trist (1965), Ansoff (1979), and Lawrence and Lorsch (1987) we can establish three types of environment:

- **Stable environment:** the characteristics of this environment are stable, simple, integrated and favourable.
- **Reactive-adaptive environment:** relatively stable, somewhat complex, diverse and quite favourable.

- Unstable-turbulent environment: dynamic, complex, diverse and hostile.

Ansoff (1985) examines both stable and hostile environments. He states that a turbulent environment is characterised by the fact that key events are increasingly difficult to predict and entail greater costs. A stable environment is characterised by few changes which are gradual, which are easier to predict, resulting in lower costs involved in relationships between organizations within the environment. Our current environment has therefore undergone a change: it has gone from being a stable environment to a turbulent environment. By analysing this environment we are able to make a reasonable diagnosis of the current and future contexts in order to detect threats and opportunities that said environment can provide for the business activities of the firm, both at present and in the future.

In terms of future trends, this analysis should be undertaken using a series of techniques that differ according to requirements as determined by the characteristics of the environment to be studied. In a stable environment that features few changes, changes arising from known phenomena, and which are therefore more predictable, will require for its analysis certain models that take as their point of departure past events and situations, assuming no changes in the behaviour of the environment's main factors or variables to determine future trends in factors. In a turbulent environment on the other hand, where changes are usually rapid, unexpected and unconnected to past experience, we require models for analysis that cannot be based on past facts or events; nor can analysis be based on hypothesis that assumes a steady state with regard to the behaviour of factors.

So it becomes necessary to understand the difference between forecasting and prospecting in order to correctly analyse the environment – be it stable or turbulent. Godet (1985) provides a basis for the definition of forecasting and prospecting as well as help for analysing prospecting and forecasting methods.

#### **f) Forecasting methods in the analysis of trends in the environment**

Forecasting involves an assessment of the environment at a certain confidence level (probability) to examine trends of variables towards a given horizon. This assessment is based on quantifiable past data and is generally taken to be valid if few, gradual changes occur in the environment.



Forecasting models do not feature an integrated or overall perspective. Models used in economic, social and technological policy forecasting use quantitative data alone and ignore qualitative variables; they are based on information which is inaccurate, offering little in the way of rigour in many of their applications. Moreover they assume a unique and predetermined future. Thus, these forecasting models have a number of limitations.

If we look at forecasting methods it should be noted that no method is better than the next. The method selected at a given moment in time and for the analysis of a specific environment will depend on objectives, characteristics and restrictions posed by the problem at hand. Forecasting methods include data fitting, analysis of time series, econometric models, analysis of statistical patterns and operations research models.

Given the complexity of the current environment and the inherent uncertainty of its future, it may be difficult to apply quantitative forecasting methods; prospective techniques may prove to be more useful in the current context.

### **g) Prospective methods in the analysis of environment trends**

Prospective methods involve possible futures, that is, scenarios that are not improbable, bearing in mind past trends as well as the interaction between actors. In this method, the future is defined both by the action of people and past factors. In light of this definition, prospective methods can be applied to those situations which exhibit abrupt changes and/or appearance of hitherto unseen events, which are consequently unpredictable if they are interpreted using past events or known patterns alone.

Prospective models take into account the possible use of qualitative variables, global view of the strategic environment and changes in position vis-à-vis the future. Prospective methods entail a global vision that is qualitative and proactive, in which the future is transformed into the present's *raison d'être*. There are multiple futures, as each is the consequence on the one hand of past deterministic factors, but also the confrontation of projects put into place by diverse actors. The various combinations of these effects will result in different futures.

Prospective methods will serve to determine a series of reasonable hypotheses which may even be contradictory and divergent regarding possible changes in the strategic environment. These hypotheses must be borne in mind by the firm when designing its strategies. Among prospective methods, the most

popularly used in recent years in the analysis of highly changing futures is the scenario-based method, the Delphi method and crossed impact method. They are of interest to analysis of strategic environment and so their principal characteristics are outlined below.

### *Scenario method*

Scenarios are used to define a future state of a known present system (or one that is at least partially known) and indicate the various processes that will enable us to move from the present to future objectives. Scenarios are defined as descriptions of circumstances, conditions or events that represent strategic environment at a given future time. Thus a scenario entails a qualitative analysis of what the future may be.

A scenario will therefore help us to better understand possible future trends. The effort undertaken by firm's management in defining these trends is of greater importance than potential results. That is to say, the importance of designating future scenarios obliges the company to take into account the relevant variables that define trends, how they interact and the possible consequences of current strategic decisions.

Applying this method involves the following stages:

1. Identifying key variables for the company and the existing relations among them.
2. Assigning a value to variables that corresponds to the probability such variable will occur.
3. Creating the most probable future scenarios.

The scenarios that are identified must feature a set of characteristics that will allow them to be used in the analysis of future environment. These characteristics follow Lanford and Twiss (1978):

- A scenario must be sufficiently exhaustive, identifying and including the principal variables that define the environment to be studied.
- A scenario must be as probable as any other scenario that is based on the same set of circumstances.
- It is important to assign probabilities to key variables a priori, with probabilities reflecting the frequency of occurrence or non-occurrence of variables.

- A scenario must be internally consistent, that is, it cannot hold contradictions which establish, for example, the simultaneous occurrence of two events which have little or no chance of occurring at a particular time.

Following these conditions, companies can devise more than one probable scenario, each based on different hypotheses. Once the scenarios have been defined, analysed and understood, management of a given company will be able to better analyse possible trends in their environment. This in turn will result in a better definition of corporate strategies and also allow a company to select various strategies for each of the potential scenarios. Thus the company is prepared to respond quickly and flexibly to possible future changes.

### *The Delphi Method*

The Delphi method is a prospective technique that is used to obtain mainly qualitative but relatively accurate information about the future. This method involves compiling opinions from a group of experts in a systematic manner through the use of a questionnaire, dispensing with open discussion and avoiding its pitfalls (and the influence of psychological factors such as persuasion). Such questions may refer to judgements regarding the occurrence (or not) of certain events.

The Delphi method is applied in stages or phases:

1. In the first stage, each expert tries to estimate the year in which certain events will occur. The results are tabulated and certain statistical indicators are calculated, such as the mean, interquartile range (IQR) or median.
2. In the second stage, experts are provided with the data obtained in the previous stage and are asked, once they examine data, to reconsider their initial answers. If one of the experts gives an extreme answer, they are asked to explain reasons why their answer is different from the majority.

The fact that extreme estimates must be justified means that experts that are not strongly convinced of their estimates will adjust their response to the median and those that are willing stand behind their estimate will restate it and defend their position. The process may be repeated once or twice until there is a convergence of opinions that will lead to a firm conclusion.

We need to bear in mind, however, that this method can only generate information about the future and therefore the predictions do not have to be very precise. To carry out this process properly, it is necessary to select experts and prepare questionnaires with care.

### *Cross impact method*

This method allows for methodical investigation into the interrelationships that exist between various forecasted events as well as the effects resulting from said occurrence (or not) of these events and the impact given events will have on the probability of other, forecasted events taking place. (Lanford and Twiss,1978).

In this sense, it is thought that cross impact occurs between two events when the probability of one event depends on another event taking place or not. If the probability of the event increases, then the direction of the impact is positive; if the probability decreases, then the direction is negative; if the probability does not change, then no cross impact exists. All of these situations can be represented in a summary matrix showing the various impacts.

It should be mentioned here that a certain degree of complementarity exists between forecasting and prospecting. It is through prospective methods that we can design hypotheses that will serve as a foundation to applying forecasting models, making them consistent with future reality. One can design, for example, a set of scenarios in which results derived from the use of forecasting methods can be used to validate the consequences of the scenarios. The combination of forecasting and prospective methods becomes a necessary tool ensuring increased accuracy and consistency in strategic environment analysis.

## 2.2.3 Internal analysis of the firm

### *The Value Chain*

- This method is useful in helping to find aspects from among an organization's business activities that are susceptible to becoming a source of competitive advantage for the company, thereby generating increased value. Popularised by Porter, the value chain is made up of all the activities that a given organization must undertake to offer its product or service, including after-sales services wherever necessary.

These activities entail a cost to the organization and customers in turn are willing to pay a certain price for said product or service. If the customer's price is higher than the cost to the organization, then profit or margin is generated from its business activity.

We can group the activities making up the value chain into primary and support activities. Primary activities are those which are part of the company's production cycle. These are:

- Factor inputs or internal logistics: activities that are necessary in order to receive factors (raw and/or auxiliary materials), storage, stock control, materials handling leading up to the production process
- Operations or production process: activities directed at attaining finished products under ideal quality, cost and time conditions.
- Product outputs, or external logistics: storage of finished products and their subsequent physical distribution.
- Marketing: activities that are part of the company's marketing actions
- Services or after-sales services: these activities maintain the product's level of utility once it has been sold.

Support activities make primary activities possible, ensuring continuity of company operations:

- Company infrastructure or management: this involves formulation of strategies, planning-control, administration, overall quality management, organization, management, information and finances.
- Human resources: recruitment, training, skills development, incentives development, participation, promotions, fostering of organizational climate etc.
- Technological development: acquisition and subsequent management of technology, which, along with other tools, the company will base its strategy design.
- Procurement: purchasing of factors needed for the production process (product components and auxiliary elements).



**FIGURE 3.** *Value Chain Model. (Michael Porter, 1995)*

The activities that are part of the value chain are interrelated; existing relations are known as linkages. A relation can be one of two types:

- a) Relations between activities in the value chain that are interrelated within the same company. These are known as horizontal linkages.
- b) Relations between activities in the company's value chain and its suppliers' and customers' value chain, known as vertical linkages.

The above demonstrates just how important it is to coordinate activities. When well-coordinated, there will be an improvement in said activities within the chain and this usually leads to a source of competitive advantage. Therefore, organizations should study the activities that make up its value chain and its links (both horizontal and vertical) to identify where a competitive advantage can be found, either in costs or differentiation, whilst anticipating possible weak points that may require correction.

The analysis of costs involves determining the cost behaviour of a particular activity and identifying any linkage that may affect said cost. The *cost driver* concept is of use here. To examine differentiation, the term *drivers of uniqueness* is used, which help to determine whether an activity is unique and different. Once these drivers have been identified, then the organization can act accordingly to achieve greater differentiation. Importantly, each of the activities of the value chain has a legal component that will have influence and can be a source of competitive advantage.

## 2.3 CONCEPTION AND SELECTION OF THE STRATEGY

Once the external and internal analysis of the intelligence phase of the strategic management process are completed, the company must analyse possible strategies to implement so as to achieve the objectives established, which will be conditioned by the results of such analysis.

After various alternative strategic solutions have been considered, a choice has to be made. For this purpose, each alternative has to be evaluated by assigning each one an index or value, depending, on the one hand, on their contribution to the objectives established and the degree of utilization of resources and competences of the company as well as the opportunities in the environment and, on the other hand, on their contribution to reducing or eliminating the company's weaknesses and the hazards or environmental threats.

Legal knowledge and legal aspects play a key role in this process. It can be one of the criteria to evaluate before taking a decision. E.g. law and regulations can be a constraint or, on the contrary, they can be an advantage for certain strategic choices (liberalisation of the energy market is an example). In the next section, possible strategic alternatives are shown, both generic competitive strategies that a company can follow and possible alternatives depending on the degree of maturity of the industry in which the company operates.

### 2.3.1 Generic competitive strategies

#### a) Cost leadership strategy

This strategy, developed using the experience effect concept as a point of departure, consists of achieving competitive advantage via cost advantage. We can say that a company has a cost advantage when its costs are lower than those of its competitors for the same or comparable product in terms of quality.

Once implemented, a cost advantage will allow a firm to undertake the following strategy:

- Reduce its prices down to its nearest competitor's margin without renouncing profits. Remaining competitors will be forced to leave the sector, save for those companies whose costs are closest to the company with the cost advantage. These companies will survive, but only with a zero or very reduced margin.

- Position itself favourably vis-à-vis its customers, as they will not be able to purchase the product at a price that is lower than its nearest competitor's cost, the price at which the leading company in cost terms will still obtain a profit.
- Easily absorb increases in the cost of resources obtained from suppliers.

### Sources of cost advantages

Experience effect. This is the principal source of cost reduction, which is based on experience or knowledge gained by members of the organization.

1. Development or adoption of new production technology that minimises costs.
2. Use of new technology in production through the redesigning of products that allows for increased savings in costs of materials used.
3. Privileged access to sources of raw materials or financial resources.
4. Favourable conditions derived from company location that could affect aspects such as salary differences and energy or transport costs.
5. The company capacity to quickly adjust production to demand. Both the underutilisation and overutilization of facilities can entail unit costs that are higher than normal.
6. The existence of economies of scale which act as entry barriers also contribute to the success of the cost leader's strategy, impeding entry of new competitors that could absorb obtained advantage.

But cost leadership strategy is not always the most recommendable as it depends on certain situations that should exist to make it appropriate, such as the following:

- Price competition between companies is a dominant competitive force, in which the rest of the companies compete in price terms.
- The product is standard and is offered by many companies.
- In cases where product differentiation is difficult.
- Cost reduction owing to a change in supplier.



- When there are many buyers and they have significant bargaining power which reduces prices.

It must be borne in mind that adopting a strategy of this type comes with its risks as soon as the competitive advantage upon which it is based disappears. This is why we need to pay attention to the risks that may arise from adopting this type of competitive strategy.

- Constant attention is required in regard to production processes; companies need to reinvest in up-to-date equipment and eliminate obsolete equipment.
- The product or market may experience a sudden change which will cancel out experience or gain in knowledge.
- Competitors can imitate or learn quickly.
- Excessive concern with keeping prices low may result in a failure to notice changes in a product. Also failure to address said changes could relegate the product to a secondary position within the market.

## **b) Product differentiation strategy**

In this strategy the company offers products or associated elements (e.g. customer service, quality, technology) that are perceived as being unique in the market. In this case, customers are willing to pay a higher price for a product from a certain company that is identified by those same differentiating features. To implement this strategy the company must possess certain abilities and skills in order to reach, maintain and develop differentiation.

### Sources of product differentiation

Product differentiation is based on

1. both tangible and intangible features of a product; it is important to mention that product differentiation is increasingly based on intangible features and here customer's perception as regards ethical issues should be taken into account e.g. when labelling the products.
2. the characteristics of the market it is oriented to: a market exhibiting a variety of buyer needs and tastes will allow for product differentiation if we know how to better adapt to said tastes and

needs. But having different features is not enough; customers must also perceive them in a positive light and be willing to pay for them.

3. the characteristics of the company manufacturing the product or providing the service: some companies have been able to succeed by way of differentiation strategies that are based on the company's style, reputation and prestige.

Differentiation strategies hinder elevated participation within the market, as they are based on an exclusive image that is usually incompatible with a high market share. In contrast, differentiation creates an entry barrier owing to brand loyalty resulting in a sector that is more protected from potential competitors. Because it creates customer loyalty, another positive feature of differentiation is that customers are less sensitive to price and profits may be increased without the need for worrying about low costs.

There are some factors which favour competitive advantage through differentiation such as:

- when product quality is important to the buyer
- when there is a potential for employing different types of technology in production
- when quality cannot be appreciated directly and therefore brand prestige acquires more importance.

Strategies based on product differentiation are more appropriate when one of the following circumstances appears:

- There is a wide range of criteria that will favour product differentiation.
- Consumer habits and needs are quite varied.
- There are few competitors using the same differentiation criteria.

But in much the same way that cost leader strategy can entail risks, product differentiation may entail in its own risks. These are listed below.

- The difference in price between a competitor following a low cost strategy and the differentiated company may be too great to maintain customer loyalty towards the brand.

- The need or appreciation for the differentiation factor may decrease among buyers.
- Imitation by competitors limits perceived differentiation.

### **c) Focus or niche strategy**

Also known as focus or segmentation strategy, this approach focuses on one market segment. Once situated in its target segment, the company will then employ cost leadership strategy or differentiation strategy. Depending on which of the latter two strategies are chosen, once the company has situated itself in a segment, the advantages and disadvantages of each strategy will hold. There is a further risk associated with the temporary nature of market segmentation; however it may also present an advantage – the firm is able to focus on one strategy for the chosen segment.

## **2.3.2 Strategies according to the sector lifecycle**

### **a) Strategies for new firms**

A firm whose presence is relatively recent is known as a new or emerging firm. These companies are in their first phase of their life cycle. These industries appear as a result of product or production process innovation.

The basic characteristics of an emerging industry are the following:

- high initial costs owing to low volume of production and lack of experience
- slow increase in demand owing to little knowledge of product on the market
- high risk owing to uncertainty surrounding a recent industry, generating a high degree of instability.

The most appropriate strategies for emerging industries are those which help to reduce uncertainty and instability, like:

- strategies that consolidate technological innovation
- strategies that configure sector structure, establishing for example product policies, marketing focus and price policies, but with an aim to attain a stronger position in the long term
- strategies of alliance or cooperation among competing firms, which provide flexibility and risk distribution.

Thompson and Strickland (1994) make numerous recommendations for emerging industries:

- Perfect technology in order to define which will dominate in the future.
- Take advantage of being first to benefit from advantages provided by suppliers and/or distribution channels.
- Look for new groups of consumers, new geographical areas and new end-use applications.
- Prepare for entry by new competitors anticipating who they will be and what strategies they will use.

## **b) Strategies for mature industries**

The characteristics of mature sectors or industries are as follows:

- There is a reduction in market growth rate, which causes competitive pressures to intensify among established firms.
- Consumers accumulate knowledge of the product given their repeated purchasing of said product, making it more costly for the firm to retain them.
- Manufacturers have also gained experience; therefore innovation opportunities are scarcer as all advances have been introduced and technology is known by all members of the industry.
- An excess of production capacity with respect to investments made during the growth phase to increase competition; as demand slows, the capacity may no longer be of use.

- Increased difficulty in developing new products as changes to products are more limited.
- There is a hardening of competition tending to focus on costs and services, resulting in product standardisation.

The most appropriate strategy to follow in a mature industry is to gain a solid competitive advantage. This can be achieved through:

- cost leadership strategy: one way of gaining competitive advantage is to reduce costs through the experience curve, economies of scale derived from product standardisation, greater cost control or increased productivity
- differentiation strategy; although the product has already been standardised, the difference can be developed through quality, service or distribution
- market segmentation strategy, focusing on a particular segment of the sector that shows growth
- reorienting firm's field of activity if sector's prospects for growth are unfavourable; firms can reorient their activities via:
  1. diversification-based strategies which involve entering new business or industries undergoing growth
  2. external growth strategy to increase market share, for example by acquiring competing companies that are experiencing economic difficulties
  3. international expansion of the company to broaden its markets and lengthen its life cycle.

### **c) Strategies for declining industries**

Declining sectors or industries present the following characteristics:

- Gradual decrease in demand without necessarily reaching total disappearance of industry, owing to changes in tastes and needs, demographic and/or technological changes.
- Aggressive price competition among firms.
- Absence of technological innovation, which results in shortage of new products.

- Unstable supply as competitors quickly change behaviour to maintain position within sector by any means possible.
- Strong exit barriers which further increase competition.

In this situation, the strategic options that a firm can take into consideration will vary according to their competitive position and the conditions of the sector itself. These strategies include:

- sector domination: dominant position, situating itself as leader
- selective reduction: identifying segment(s) within the sector which still maintains or allows for high profitability and focus on them
- harvest: reduce necessary investments to a minimum and take short-term advantage of any source of income, including the selling-off of original investments
- divestment: recover initial investment by selling the company when the sector begins to decline.

### 2.3.3 Actual growth strategies

The concept of company growth refers to increasing company size which results in a change with respect to its previous state. Growth strategy is the type of strategy that corresponds to the growth phase of a firm's life cycle.

Company growth may appear as a result of its adaptation to the environment, and it has become a matter of course for companies operating in modern and dynamic economies; yet it is still the result of a specific strategy.

The basic issues under consideration when formulating a growth strategy are: deciding between specialisation or diversification, internal or external growth and whether to expand internationally or not. A company's growth strategy will combine aspects from all of these decisions.

#### a) **Diversification vs. Specialisation**

The term *diversification* can be understood as the growth of a company arising from the introduction of a new product into a new market; this also can be seen as fulfilling a new mission. This strategy involves adding a new product-market relationship or a new activity that is different from existing activities, thereby modifying the firm's field of activity.

*Specialisation*, on the other hand, results in either market penetration or market development; the former involves greater efforts to increase company presence in its market and products, and the latter seeking out new markets for its current products or product development by offering new products within its current market.

*Diversification* may be induced by exploiting company competences. Companies may possess resources and skills that are underused by existing business activities or possess capacity which is unlimited and that could also be exploited for other activities.

There are two main ways to diversify:

- 1) Concentric or homogeneous diversification which initially means entry into new business activities that are related to the company's existing business either technically or commercially.

Concentric diversification can be further broken down into two types:

- Horizontal diversification which, according to Ansoff, is characterised by similarities between new and current customers, using the same distribution channels.
  - Vertical diversification or vertical integration, where the company participates in activities situated on other levels of the production chain. This can either be in a backward direction, in which the company takes over an activity of one of its suppliers, or forward direction, by which the company incorporates the activity of one of its customers.
- 2) In conglomerate diversification, there is no relation between new activities and activities existing before diversification.

## **b) International expansion strategy**

When a company begins to operate in a geographical region different from its own in a stable, non-sporadic manner, we can talk about an international expansion strategy.

There are different ways of penetrating foreign markets; the chosen strategy will depend on the reasons why the company wants to expand internationally. Entry strategies depend both on internal factors and the objectives sought by the firm and their association to time in addition to external factors such as regulations

imposed by governments on imports or direct foreign investment, tax breaks and incentives, transport costs, existing competition, availability of qualified personnel, raw material or intermediate products in the target country.

An examination of these factors will help us determine various ways of organising transactions through the company, market, or by way of hybrid or intermediate channels. The company's decision will be influenced by transaction costs and its organizational capacity.

In addition to the above variables, there are two new factors that need to be borne in mind as a complement to analysis: political risk and country risk. Political risk refers to an assessment of the political stability and level of government intervention that exists in the target country. Country risk is not entirely associated to changes in exchange rate as it pertains to the level of solvency or economic strength of the target country. Both factors will play a decisive role in the selection of one form of investment or another.

An initial classification of entry modes involves distinguishing between exports and direct investment, where in both cases the company may initiate its activities alone or in collaboration with other companies. The fundamental difference between export activities and direct investment lies in the fact that in the former, the company is transferring a product from one country to another whereas in the latter activity, in addition to moving a product the company is also moving resources, technology and know-how. Let us examine the principal modes of entry into foreign markets: exporting strategy, licensing and foreign direct investment.

### *Exporting strategy*

This method is characterised by being the simplest and the most traditional way of initiating international expansion. Production is maintained in the company's country of origin, which supplies the various markets.

There are two advantages to this option:

- It avoids costs involved in establishing manufacturing operations in the host country.
- It is consistent with economies of scale based on economies of localisation and the experience curve.



Exporting activities can be carried out via an external organization that can contribute experience on distribution, marketing, negotiation and administrative skills in handling agreements of this type or through the company itself. In the latter case direct sales are made through representatives or sales offices located in the foreign country.

Nevertheless, the high costs of transport and tariff barriers could make the exporting option unattractive. There is also an added risk of having to delegate sales activities to local agents that may act in their own interest.

Exporting is a good option in the following cases:

- The company is small and does not have the means to manufacture in the foreign country.
- When manufacturing in foreign countries poses a political risk; the foreign country market is unattractive or exhibits uncertainty in prospects.
- There is no political or economic pressure on exporting activities.

### *Licensing*

Licensing or indirect investment activities are those in which capital is not provided by the original company. There are two basic types: licensing and franchising.

1. Licensing. International licenses are agreements by which a foreign licensee purchases the rights to manufacture products of a given company in their country, with the licensee providing the majority of the capital in order to carry out operations in the foreign country.

The main advantage offered by this option is that the company does not have to assume costs or risks associated with entering a foreign market, making it an attractive option for companies that lack capital or that do not wish to make considerable investments in an unknown market or at an excessively high risk.

But licensing also comes with a series of disadvantages as companies do not have absolute control over manufacturing functions, marketing or over strategies employed by foreign licensee. This is not an ideal option for companies that seek strategies that involve a high degree of international coordination and integration, or for companies that would like to combine strategic movements

from a global perspective. In addition this option entails a risk associated to authorising the use of know-how by other companies, know-how upon which competitive advantage is based.

2. Franchising. The above option is used by manufacturing companies, whereas franchising is an option principally entered into by service companies. Limited rights to use the brand are purchased by a franchisee allowing them to make use of a brand, where the company purchasing said rights must adhere to the franchiser's strict norms governing how the business should be run.

The advantages of franchising are similar to those of licensing (the company does not have to assume risks or costs associated with entry into a foreign market), but with fewer disadvantages as there is no pressure to seek out low cost solutions by way of an experience curve or through economies of localisation. Still, there are limitations to strategic coordination at a global scale.

In both cases, the company granting the license provides the licensee with the technology needed to develop the firm's business activities in a foreign market. The company that obtains the license also obtains a competitive advantage as it has access to information that it could not access otherwise. The company granting licensing rights obtains access to a foreign market at a reduced investment along with the prospect of attaining knowledge of the new market.

### *Foreign direct investment*

Foreign direct investment involves a commitment by the company to invest capital abroad. Investment of this type comes in two forms, according to whether investment is made with a partner or individually: joint ventures or creation of subsidiaries.

#### 1) Joint ventures

In the international sphere, joint venture companies are defined as companies that carry out their activities in a foreign market but are not wholly owned by parent company. This definition includes any combination of two or more shareholders (foreign or national) participating in the joint venture. The joint venture entails a greater commitment when compared to the international activities required of exporting activities or licensing, and also involves greater risk and less flexibility for the company.

An important reason for forming joint ventures is the political pressure which could force a company to manufacture its products in the foreign country that imports said products. This type of company is an option for those wishing to share the burden of financial and political risks associated to entering a foreign market.

The advantages of this option lie in that it represents a potential for learning as it makes use of the local partner's knowledge of the market, providing the foreign company with technological know-how and products whilst sharing risks and costs.

This option also entails disadvantages. The company runs the risk of losing control over its know-how (as in the case of licensing), and it cannot fully control its subsidiaries. These drawbacks, nevertheless, can be mitigated if the company participates in the joint venture as a majority shareholder.

## 2) Subsidiaries

A company may own subsidiaries to produce units that are sold in local markets that originate from its own country. The fundamental difference between joint venture companies and subsidiaries is that the latter strategy ensures full control over operations, avoiding inflexibility of the former and the undesirable sharing of management.

This is a good option when the competitive advantage of a company is based on full control of certain technological skills. Opening a subsidiary is the best option as it reduces the risk of losing this control. This strategy is also preferable when the company requires its strategies to be coordinated at the global level or when it wants to take advantage of cost advantages.

Nevertheless, opening a subsidiary is the most expensive form of foreign direct investment, involving major risks that are derived from poor knowledge of the new market. Although the latter drawback can be addressed through acquisition of companies established in the foreign country, this entails a further problem associated to the differences in corporate cultures existing in each of the countries.

### c) Innovation as a business strategy

In addition to the growth strategies that a company can implement, and due to the characteristics of the current environment, companies should focus their strategy to innovate across the board in all areas of activity, not only in regard to what products and services. In short, companies should adopt a strategic innovation management approach focusing on the exploitation of knowledge and internal resources of the company. Innovation should be understood as a dynamic process where the set of resources and capabilities of the company plays an important role in its overall competitiveness.

This new concept of strategy and innovation must be directed to seeking long-term competitive success. It is based on the capabilities of the company to leverage knowledge and turn it into valuable innovations in any area of the organization. Following are some definitions of innovation strategy coined by various authors in the field of business management and innovation:

- Hamel (1998) defines innovation strategy as the ability to recycle which exists in the different industry models from which value for customers is created, overtaking competitors with new products and providing shareholder wealth.
- Schlegelmilch et al (2003) define innovation strategy as the re-conceptualisation of business model (breaking the established roles and changing the form of competition), achieving a higher value for customers and growth for the company.

We find that the definition of an innovation strategy is aligned with the overall organizational strategy, and that it does not differ (with the exception of the concepts of recycling and re-conceptualisation that leads to innovation) of the operation of any other type of strategy within the organization. That is, to implement an innovation strategy, the following characteristics must be taken into account.

- Consider innovation as a part of business strategy; it is therefore important that the culture of innovation spreads from the upper levels of the organization to the bottom, i.e. with a commitment to such strategies from the units' decision-makers.
- Defining an Innovation Strategic Plan for the organization (strategic options, implementation and control); as with any strategy, for its implementation, it must be composed of a series of stages or phases that must necessarily be met to ensure proper subsequent implementation and control.

- Assign tasks, responsibilities and budget; the general outline of the strategy should be broken down into more operational objectives so as to enable the company staff to undertake all the activities that will support them. This is nothing more than providing innovation with a structure so that objectives can be reached in the short term and, through the subsequent attainment of these goals, the long-term objectives defined in the innovation strategy are also met.

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# 3 INNOVATION MANAGEMENT

*Amparo Camacho & Enrique García*

## 3.1 INTRODUCTION

Innovation in companies has probably never been as important as it is now. Only companies that are capable of innovating and offering something new to the market will be competitive and able to survive in the new economy. Nowadays we can find a multitude of definitions of what innovation is, each one having its variations. We could say that innovation is responding in a creative way to an organization's needs, and to society in general, with products and services that are increasingly adapted to those needs so that the value perceived by the market is greater.

The current environment is defined by a growing dynamism, uncertainty and turbulence, which are reflected in

- a progressive globalisation of markets
- a reduced life cycle of products
- faster technological changes
- continuous changes in customer purchasing values (growing consumer concern about ethical issues)
- economic turbulence.

This context requires from companies an on-going improvement of competitiveness and a higher degree of competitive intensity, that is, they need to generate long-lasting competitive advantages. A commitment to innovation as an instrument for the creation of value in companies should be based on a series of processes and capabilities which should be present in all companies and which are expressed through the interaction of their members with each other and the environment.

Innovation refers to all those characteristics and attitudes that enable knowledge creation, learning, and knowledge transfer, contributing value to the market in a successful way. The process of creating and exploiting knowledge in

order to create value involves various stages, the first of them being capturing information from the environment and identifying opportunity spaces.

In the introduction to the previous chapter, it was stated that the goal of proactive law for legal professionals is to become “multi-dimensional” professionals in order to serve their clients better. This requires professionals in the legal practice to obtain knowledge and skills to think proactively and to develop capacities to provide proactive legal services and contribute to the goal of using law as a source for sustainable competitive advantage and for the creation of value.

*Managers who view the law purely as a constraint, something to comply with and react to rather than to use proactively, will miss opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm.<sup>129</sup>*

Lawyers can contribute to exploration and innovation processes in a way that no other area of the company or its environment can, as there are many opportunities that may arise by using law and legal instruments in a proactive way. By empowering lawyers to become key actors in exploration and innovation processes, companies increase their innovative capability and therefore their sources for sustainable competitive advantage and value creation.

## 3.2 CONCEPT AND TYPES OF INNOVATION

The concept of innovation or innovating can be described as follows:

- generating or finding ideas as well as selecting, implementing and marketing them
- a process in which, starting from an idea, invention or need recognition, a product, a technique or a useful service is commercially developed and accepted
- set of activities in a certain period of time and place resulting in the successful introduction into the market, for the first time, of an idea in the form of a new or better product, service or management and organization method.

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129 Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378, 378-79 (2008).



These definitions of innovation have three very important elements in common:

1. Innovation stems from an idea or opportunity identified.
2. By the means of a process which involves analysis, selection, implementation and launching, this idea is put into the market.
3. The results of innovation have to be accepted by the market, otherwise they cannot be considered as true innovations.

The most important part of the definition is that innovation is a process, and as such, it can be managed: it can be organised, controlled, planned, implemented, systematised and measured. Therefore, Innovation Management can be defined as a process aimed at organising and managing available human and financial resources with a view of creating new knowledge, generating ideas to obtain new products, processes and services or to improve existing ones, and transferring those ideas to manufacturing and marketing phases.

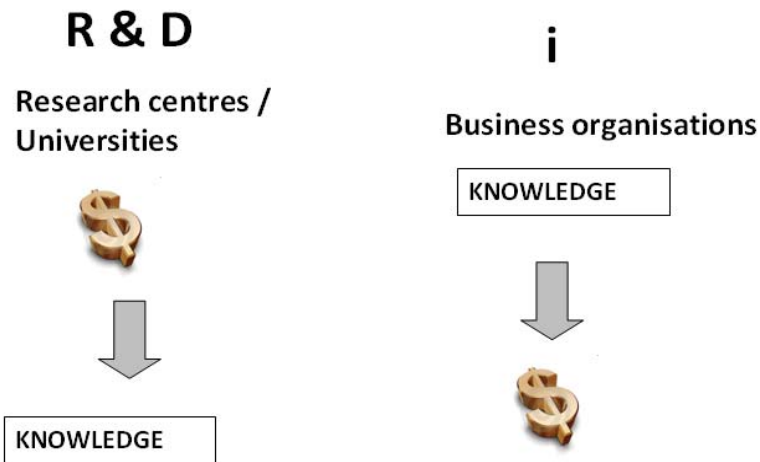
It is necessary to break certain myths about innovation and promote the view that innovation is not only about product development or the latest technology. It is a characteristic of the working community and a feature in the corporate culture; it is about abilities which can be learnt and promoted, because it is the people, not the companies, who innovate.

We can distinguish various types of innovation according to the area affected by it or where the innovation is primarily located in a company:

- **Goods or services (commonly known as product innovation)**, which refer to the introduction of new or significantly improved products as far as functional features or uses are concerned.
- **Process innovation**; the implementation of new or significantly improved production or distribution methods, generally developed by means of equipment, techniques or software.
- **Marketing methods innovation** (product/price/market/promotion), involving significant changes in the design, packaging, sale, positioning or price of goods or services.
- Innovation in **organizational methods**, which deals with the implementation of new methods in business practices, organization of the workplace or the way the organization's external relations are developed.

- Innovation in the **business model** occurs when different innovation types are simultaneously combined, which usually enhances the final impact.

What is the relationship between Research, Development and innovation? It is summarised in the figure below.



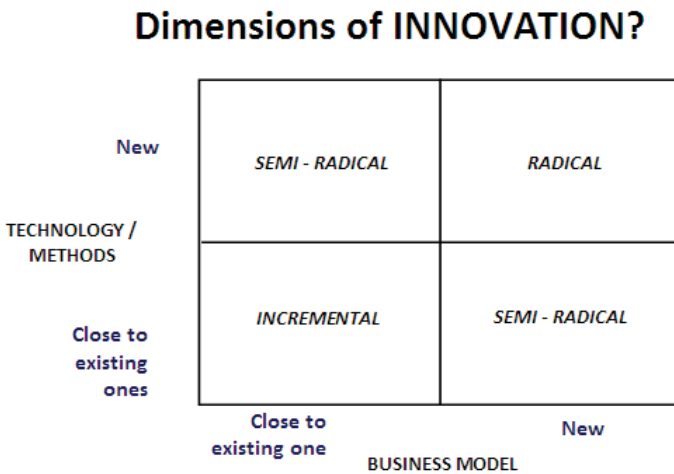
**FIGURE 4.** *The relationship between Research, Development and innovation.*

While research centres, universities, and R&D departments at companies focus on transforming money into knowledge, the aim of innovating is to use knowledge in order to create value and, as a result of that, economic benefits.

If we look at the intensity of innovation, it can be classified into Radical, Incremental or Semi-radical innovation:

- **Incremental innovation**, referring to small changes aimed at increasing the company's functionality and performance; if cumulative, they can make up a strong basis for progress.
- **Radical innovation**, referring to breaking away from established modes and producing new products or processes that cannot be understood as the natural evolution of the ones existing in the company.
- **Semi-radical innovation** is a combination of both radical and incremental innovation.

The figure below identifies Incremental, Radical and Semi-radical innovation according to the methods or technology used to generate it as well as the business model resulting from it.



**FIGURE 5.** *Dimensions of innovation.*

*The Innovation Portfolio*

In order to guarantee an appropriate balance between the various types of innovation, it is important for companies to define their Innovation Portfolio, which includes the objectives to be achieved, the expected results and the resources required as well as the time schedules. Innovation Portfolio helps to maintain an adequate combination of Incremental, Semi-radical and Radical innovation projects in line with the company’s strategic objectives and available resources. In order to grow in the long term and maintain a competitive advantage, companies require innovation projects of the three types described.

### 3.3 RULES FOR INNOVATION MANAGEMENT

As other management processes, innovations require certain tools, procedures and mechanisms for them to be appropriately displayed at organizational level. Below are some rules which are strongly recommended to be taken into account, as the opposite may hinder the process.

1. Strong leadership in innovation strategy and decisions. Innovation management must be present at the highest organizational level to ensure that it spreads throughout the organization.
2. Integrating innovation in the basic business mentality of the company. Innovations must be an integrated component in the company's daily operations.
3. Aligning quantity and innovation type to the company's business. Innovations can be key to a successful overall business strategy; innovation types and their numbers must be determined in order to support the business strategy (more is not necessarily better).
4. Handling natural tension between creativity and value capture. A company must be strong in both dimensions. Creativity without the skills needed to turn it into usefulness can be fun but unsustainable; usefulness without creativity is rewarding, but only if it works in the short term.
5. Neutralising organizational antibodies. Having a clear position and strategy to neutralise and build beyond reactions to change. Innovation needs changes, but change causes explicit routines and cultural rules to either block or deny change.
6. Recognising that the basic unit (the basic building block) of innovation is a network consisting of people and knowledge both inside and outside the organization. A successful organization knows how to pool internal and external resources.
7. Creating an adequate system of innovation measurement and reward. People react to positive and negative stimuli, and innovation in a company is not the exception; the required innovation level will never be reached if people are not adequately rewarded.

### 3.4 THE AMBIDEXTROUS ORGANIZATION

The concept of an “ambidextrous organization” was developed by Michael L. Tushman and Charles A. O’ Reilly III in their similarly named book (1997). It is a description of organizations which “separate their new, exploratory units from their traditional, exploitative ones”. Ambidextrous organizations are capable of balancing the exploration of new opportunities with the appropriate exploitation of the present ones (anticipating problems, managing risk and taking adequate decisions in a creative way). This model suggests a balance between efficiency & supporting activities (oriented towards exploitation of current opportunities) and explorative activities to give way to innovations and to be able to face new competitive scenarios in the mid-long term. To that end, it

- separates new units, of the explorative type, from those that are more traditional, of an exploitative nature, permitting in each of them the application of different types of processes, structures and cultures
- at the same time, keeps strong relational links (vision, common values and incentives) between units at a managerial level.

**TABLE I.** *The difference between the Exploitation and the Exploration areas within an Ambidextrous Organization.*

	<b>Exploitation</b>	<b>Exploration</b>
<b>Strategy</b>	Costs	Innovation
<b>Critical objectives</b>	Processes	Radical innovation
<b>Competences</b>	Operational	Entrepreneurial and proactive
<b>Structure</b>	Formal	Adaptable
<b>Objective</b>	Margin, productivity	Goals, growth
<b>Culture</b>	Efficiency, low risk, quality	Risk, speed, flexibility, growth
<b>Leadership</b>	Authority	Visionary

In other words, an Ambidextrous Organization

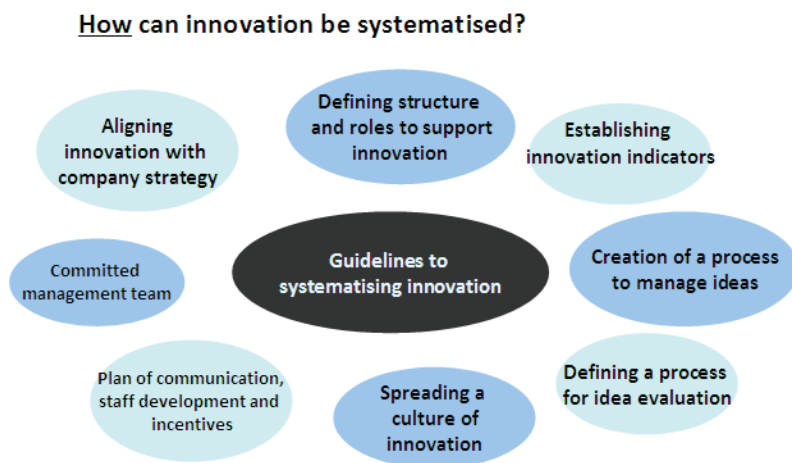
- favours Incremental and Radical innovation
- allows growth between units while preventing cross contamination between them
- promotes the coexistence of processes, culture and structures
- permits harmonic, agile and rapid coexistence of daily activities (organization for execution) with innovation project activities (organization for creation)
- allows paying attention to processes and products from the past, but at the same time to looking ahead and preparing for those innovations that will define the future.

### 3.5 SYSTEMATISING INNOVATION

#### 3.5.1 Guidelines for systematising innovation

Why is it necessary to systematise innovation in organizations?

- It contributes to avoiding innovation being a just “spark” by a single person in the company (it guarantees repeatability).
- It makes innovation a consistent “daily practice” in the organization.
- It permits to establish processes of innovation that can be planned, managed and measured.
- It permits to define an innovation strategy.



**FIGURE 6.** *How can innovation be systematised?*

**a) Having a committed management team**

- It permits a culture of innovation to be made visible.
- Necessary for incorporating innovation into company strategy.
- Innovation spreads from top to bottom.

**b) Aligning innovation with the company strategy**

- Innovation is considered one more element in the strategy.
- The organization's Strategic Plan for Innovation is defined (strategic options, implementation and control).
- Task, responsibility and budget are appropriately allocated.

**c) Plan of communication, staff development and incentives**

- Disseminate importance of innovation among organization members.
- Empower them to become motivated in this task (by means of training and the use of practical tools).
- Establish mechanisms for recognising the work done by the staff (contributing ideas, being part of the process etc.).

**d) Spreading a culture of innovation**

- Companies do not innovate, people do.
- Innovation is exploring "the unknown", doing different things.
- Failure must not be punished as doing so discourages people.

**e) Creation of a process to manage ideas**

- Establish a formal process (non-bureaucratic) for collecting ideas.
- It is necessary if ideas are to be collected from all organization members, regardless of their position and responsibilities.
- Reduces time from ideas collection to implementation.

**f) Defining a process for idea evaluation**

- It is complementary to the process of idea generation.
- Criteria for idea evaluation and selection must be established:
  - How are ideas evaluated
  - Criteria to be met
  - Who makes decisions
  - Etc.

**g) Defining the structure and roles that support innovation**

- This structure must be defined to let ideas "enter" the company's innovation process.
- Existence of "leaders" who stimulate the "input" of ideas.
- Person responsible for coordinating the structure as a whole.

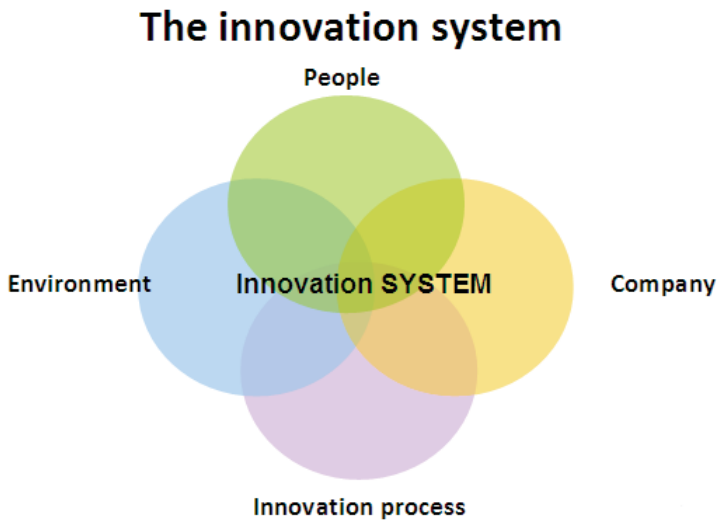
## h) Establishing innovation indicators

Indicators are needed in this process to measure things:

- Input indicators (people who participated)
- Process indicators (ideas processed, time)
- Output indicators (projects implemented)

### 3.5.2 The innovation system

The Innovation System synthesizes and defines the core elements of innovation and the interaction between them.



**FIGURE 7.** *The innovation system.*

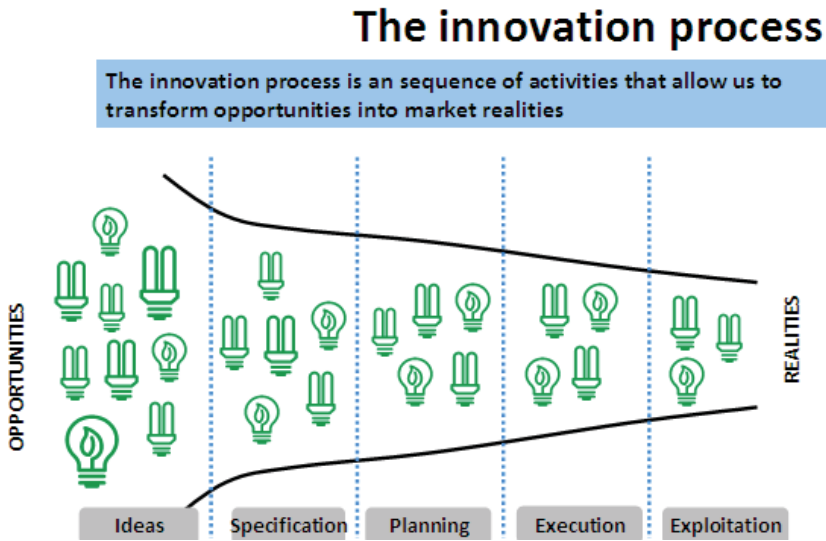
The innovation system is composed of four key elements:

- company itself
- company's environment
- people in and outside the company whose knowledge is put at the innovation system's disposal
- innovation process.



### 3.5.3 The innovation process

As seen in the figure below, the Innovation Process is a sequence of activities that allows the transformation of opportunities into market realities.



**FIGURE 8.** *The innovation process.*

There is not a single model for an innovation process. However, there are some key elements that are commonly found, and which are related to the characteristics of human intelligence applied to organizations. Organizations are implicit and explicit rules and agreements individuals adopt among them and with the society, with the aim of sharing their knowledge and creating new knowledge as a consequence of their interaction among them and with the environment, to create value and satisfy their needs. Individuals are the organization itself.

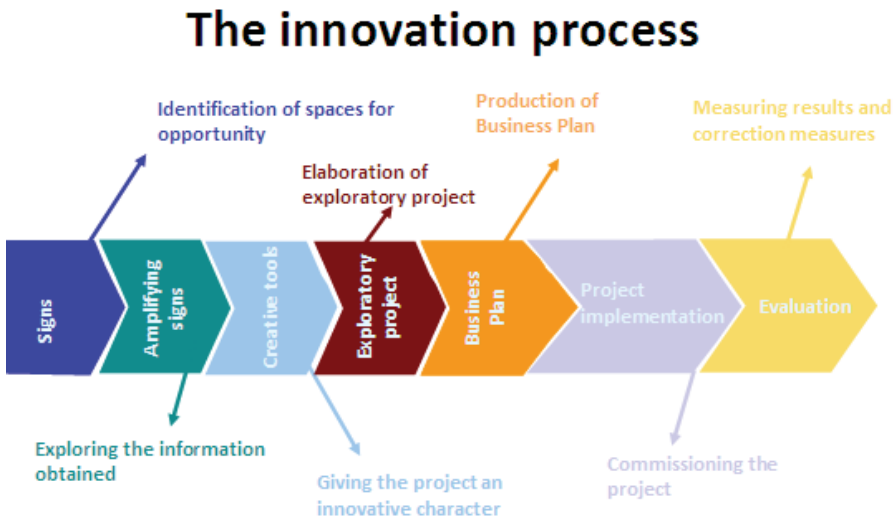
Although intelligence is an individual process, the combination of individuals with different learning patterns shows that their combination provides us with more intelligence. The ability to learn increases when carried out as a team; individuals are able to exchange their knowledge, to increase the ability to individual learning and to create new knowledge through the combination

of the knowledge shown by each individual by the means of acting jointly – reflecting, theorising and being pragmatic.

If we take into account the characteristics of individual intelligence, the following characteristics of the organizational intelligence can be established:

- recognising the evolutions of the environment
- reacting to the evolutions of the environment in an efficient way
- learning ability; facing problems more efficiently or with less chance of making mistakes in the second and third attempts
- interconnection for the development of higher quality solutions (innovations)
- being able to transfer the resulting knowledge to situations other than the original one (that is, exploiting knowledge).

For the purpose of this handbook, the following innovation process model has been chosen, as it gathers the main elements described above.



**FIGURE 9.** *The innovation process, expanded.*

#### a) Capturing information from the environment in the form of “signs”

A “sign” is all the information, regardless of its origin and format, susceptible to being analysed in depth and that can be considered an indication of a potential

business opportunity. Signs can be found anywhere and in any format. Below are some examples:

- family
- friends
- colleagues
- readings
- clientele
- workshops
- companies
- organizations
- competitors
- suppliers.

As signs to be found in the environment can refer to any field or topic, the company must define some “Fields of exploration” so as to make sure that not all the signs are collected (it would make the process of analysis impossible) and, most importantly, that signs are collected in relation to those areas which are a priority to the company. Signs should be collected by all members of the organization and also, if possible, by actors outside the company. They can be provided physically or virtually (by means of appropriate tools such as email, forum etc.). For physical collection, visible panels are advisable, located in adequate places.

### **b) Amplifying signs**

This process seeks to go deep into the information (both qualitatively and quantitatively) for the data to become more reliable. The idea is to decide on which signs are relevant, and thus what should be taken into account for further analysis and what should be discarded.

Some sources of information to be used in the signs amplification process are:

- distribution channels
- suppliers
- advertising agencies
- personnel hired by competitors
- professional associations
- industrial associations
- R&D centres
- universities
- articles
- newspapers and magazines

- governmental documents
- management speeches
- analyst reports
- patent records.

### **c) Use of creativity tools**

Once the decision has been taken about those signs which are relevant (because they are providing information about a possible future opportunity) it is necessary to define a creative focus and to generate ideas which respond, in an original and innovative way, to the information provided by the sign. The definition of an appropriate creative focus is very important since it will condition the process of generating ideas. The creative focus can be described as the reason why ideas are generated, or the purpose of those ideas, for example: “we want to generate ideas to find new ways to relate to our customers”, which is different from “we want to generate ideas to find new customers (or new markets)”.

After the creative focus has been defined, various techniques can be used to generate ideas. If we want to generate a great deal of ideas to choose from, Brainstorming or Brainwriting are recommended. However, if the aim is to find new innovative elements to an already existing idea or a problem, certain more complex techniques can be used, such as the Forced Morphological Connections or SCAMPER. These techniques can be widely found in literature about the subject. They provide new ways of analysing the nature of the problem, or sign, and generate a wide range of options for solution. After generating or further developing ideas using creativity techniques, the resulting ideas must be evaluated and a decision must be taken to discard them or continue with the process.

### **d) Exploratory project: development of a business opportunity**

The Exploratory Project can be described as a brief concise document collecting information compiled in the previous sign amplification phase and idea generation process, permitting to visualise key aspects of a possible future business unit, product or measure.

One should be able to respond to the questions below, before deciding to produce a Business Plan:

- product or service offered, or measure to be implemented
- client typology targeted (it can be internal or external)
- needs to be satisfied
- differential elements offered
- analysis of the competition / substitutive products or measures
- business model / concept (how we are going to provide the said product, service or measure).

The process of filling in the above information is in fact an exploratory process, because it forces us to actually simulate the possible launching of the innovation that has been defined.

#### **e) Drafting of a Business Plan**

The Business Plan includes the key elements that will allow us to effectively manage our new company, business unit or measure to be implemented.

- It includes the main areas of development of the future business opportunity.
- It permits us to validate their economic feasibility.
- It must be clear, straightforward and specific.

#### **f) Launching the new project or business opportunity**

The new business unit, product or service is launched into the market in this phase. It is essential to appoint a person who will be responsible for the launch as a project manager, and who will also be responsible for creating a team. At the beginning of the innovative business project, some special requirements have to be taken into consideration. For example, it would not be logical to ask the new unit the same benefit rate as in other more consolidated units or areas.

#### **g) Evaluation**

The results obtained by the new unit or product must be measured in order to guarantee its appropriate development and also in order to foresee correcting actions, if necessary, so as to correct deviations. Indicators must be put in place. Here are some possible indicators which can be used to measure the results obtained as a consequence of the innovation process being implemented.

- revenue growth resulting from new products or services
- client satisfaction with new products or services
- number of ideas or concepts in process
- innovation expenditure
- percentage of sales of new products/services
- number of new products or services launched
- investment return from new products or services
- number of innovation projects in which the company participates
- number of people actively involved in innovation (explorers)
- profit growth resulting from new products or services
- prospects of new product/service portfolio
- change in market share as a result of new products or services.

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## 4 ORGANIZATIONAL SKILLS: PROACTIVE BUSINESS CULTURE

*Patricia Santateresa*

After dealing with proactive management at strategic level and defining the process of innovation which leads to creating value from opportunities identified, this chapter addresses the promotion of proactive behaviour at organizational level, that is, the proactive business culture. There is some difficulty in recognising both organizational and individual skills as well as identifying business performance and/or dynamic and proactive professionals (i.e. that are ahead of people or events). Seen that, defining what characterises “proactive behaviour” leads us to reflect on the definition of such behaviour.

The importance of this concept came with the proximity of the new millennium. In the early nineties, the behaviour of companies changed so as to adapt to new market trends characterised by dynamism and uncertainty never seen before. This forced many companies to decentralise their organization and to trust in the initiatives of their employees to identify and solve problems. For this reason, a proactive behaviour has been regarded as a success factor in business organizations, increasing the efficiency of their management (Bateman & Crant, 1999).

Among the forces driving this process of change – in the search for greater dynamism and competitiveness – four factors can be differentiated.

### 1) Technology

- ability to move technological advantages to smaller units
- access to technology.

### 2) Economic opening

- intensification of competition
- decreased transaction costs
- rethinking of organizational costs.

- 3) Permanent relocation of activities
  - optimization of the efficiency
  - rationalisation of logistics
  - increasing the relevance of the virtual.
- 4) Changing values
  - primacy of the person
  - greater demands on people
  - new attitudes and behaviours.

According to Garcia-Echevarria (2003), it must be stressed that the main factor that has primarily transformed organizations is the change of values, which led to abandon a reified culture in the company, in which control of the structure was contractual, the behaviour was unified and a profound rigidity was found (both process and bureaucratic), all of which generated adaptation costs. This abandonment favoured a person-centred culture, increasing emphasis on the ability of the person to contribute their values and competencies to respond to business transformation processes. In this sense, leadership, uniqueness, flexibility and integration of individuals into the corporate culture become relevant.

Also, according to Crant (2000), this is in contrast to a more passive, reactive pattern of behaviour. Proactive people actively seek information and opportunities for improving things; they do not passively wait for information and opportunities to come to them. For example, Frese et al. (1997) described the concept of personal initiative as involving an active and self-starting approach to work. Bateman and Crant (1993) argued that proactive individuals actively create environmental change, while less proactive people take a more reactive approach toward their jobs. One theme of Ashford and her colleagues' research on proactive feedback seeking (e.g., Ashford & Cummings, 1983, 1985) is that many people are not simply passive recipients of information at work; rather, they actively seek it. Similarly, the concept of issue selling (e.g., Dutton & Ashford, 1993; Ashford, Rothbard, Piderit, & Dutton, 1998) involves middle managers actively shaping the strategic planning process by calling attention to particular areas of interest.

We can also note that the proactive company should involve the entire organization, since it must not be one's own behaviour but any employee thereof. Proactive management facilitates exchange, communication, interaction, coordination and control within organizations, as well as networking. These activities generate a type of network capital that can be



translated into improvements in the performance potential of the organization (Toole and Goerdeler 2005).

In this way, the purpose is to gain knowledge (while also disseminating it) about the operation of the network and simultaneously to obtain accurate information in order to make important decisions and judgments concerning the organization (Simon 1997). Similarly, managers engage in proactive behaviour in order to maximise programme benefits and minimise future losses in terms of programme outputs. This is achieved, in part, by attempting to avoid ambiguous situations (that is, by adopting uncertainty avoidance). More specifically, proactive management reflects efforts by managers to maximize potential benefits (organizational or network), while at the same time reducing uncertainty about the future of those benefits.

The argument thus follows that managers reduce uncertainty by proactively managing network actors. Considering the point more broadly, proactive management behaviour is also characterised as part of a larger power structure erected by the manager in order to (1) induce strategic collaboration among network actors and (2) to control, to some degree, their environments (Kickert and Koppenjan 1997). Decisions emerging from such activities are motivated by a utilitarian rationale in order to gain access to resources and minimise negative environmental inputs (Raab 1999).

In this sense, Garcia-Echevarria (2003) suggests that the future of organizational structures will be networked in order to gain flexibility and speed in their communications. This will be so that managers can share knowledge with the rest of the staff, but not through command or contractual structures, but through the integration of the individual and their contribution in a dialogue structure. Integration implies sharing values and goals, enriching the people themselves through increased knowledge.

For this proactive orientation to be carried out, managers must possess skills that contribute to this integration. This is why every manager must have not only specific skills required in their own sector, but also know how to manage different value systems to conduct this cultural shift towards the common shared values. The management of individual skills through team work contributes to the generation of collective intelligence that, after all, leads to the development of “organizational skills”. Thus in relation to these organizational competencies, companies will have a competitive advantage and will manage the same according to what the organization does, what it is

capable of doing and what it wants to become in the future – in relation with organizational strategy (Morcillo, 2006).

Also moving towards a proactive management approach implies trying to anticipate problems and difficulties which can be expected to arise, and planning for specific action to avoid or minimise them. Obviously this approach does not remove the reactive-type actions, since no matter how very accurate and precise planning can be, there will always be unforeseen problems that need to be addressed in the most effective and efficient manner. Therefore, a proactive culture within the company must have a vision in the short, medium and long term, and for this it must be supported by an integrated management system, framed at the strategic level (Pereda and Berrocal, 2006).

To implement an integrated management approach, strategic objectives and plans should be previously defined within the company. When a proactive perspective is considered, the first step is to define the company's strategic objectives to subsequently develop a strategic plan for the whole organization. In a second stage, this strategic plan will become the operational (or tactical) objectives of the various business units of the company, defining the programmes and action plans that will make it possible to achieve the expected objectives on time.

At this point it should be noted that Human Resource Management has the lead role in this issue, since the strategic planning for this unit will serve as a basis for defining the objectives of every other management unit.

So the organizational strategy and Human Resource Management is closely related, since the objectives and business plans will define the framework within which the company's human resources will be managed, supported by two pillars: jobs and people (Pereda and Berrocal, 2006).

#### **4.1 HUMAN RESOURCE MANAGEMENT FROM A PROACTIVE PERSPECTIVE**

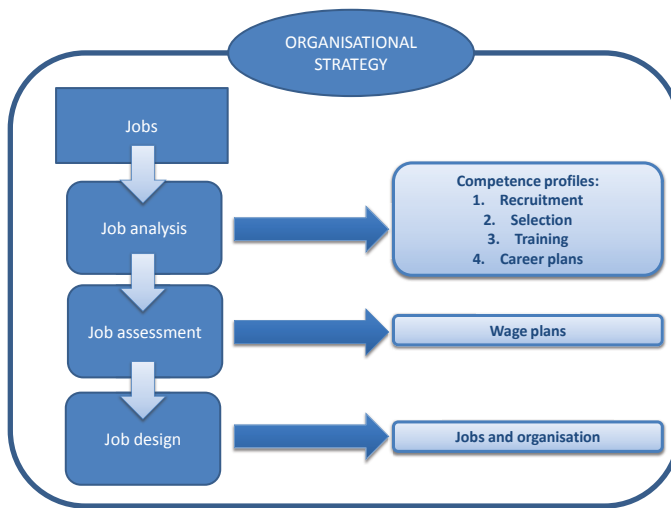
Traditionally, companies have used the term “job” to refer to all the functions, tasks and responsibilities assigned to a person within an organization. By introducing the concept of competence, and in view of the new systems of business management and organization, the concept of “job” is transformed into “occupation”; in some cases and more generally, “role” is used. This new

terminology tries to move away from traditional job descriptions, often too comprehensive and rigid, to allow the necessary flexibility and versatility to respond to today's labour market requirements and to the constant need to anticipate changes and adapt to them.

However, flexibility and versatility must be understood within limits in which the person will perform different functions within a field of activity, but will also, in many cases, be required to have knowledge about other areas related to his/her work, so as to collaborate with other professionals. To develop an accurate description of "new" jobs or occupations, it is necessary to carry out a job analysis and to define a requirement profile.

The requirement profile aims at defining the skills that should be met by persons occupying the job, so as to respond appropriately to the activities and responsibilities contained therein. These profiles will be the starting point of recruitment and selection programmes. They will also define the training requirements so that, on the one hand, training programmes may be developed, tailored to the needs of the organization, and on the other hand, career plans may be defined logically and consistently with career paths matching the organization's requirement profiles.

Job position analysis will enable the company to assess the importance each job has to achieve the objectives of the company, and this assessment will serve as a starting point to develop wage plans in relation to achieving those objectives. Furthermore, this information will form the basis for the design and re-design of jobs and, when necessary, of the organization. The following figure collects the activities involved in a definition of jobs within proactive organizations.



**FIGURE 1.** *Job description (Adapted from Pereda and Berrocal, 2006).*

Also, from an integrated Human Resource Management perspective, each staff member should be assessed individually, each with their skills, interests and motivations, thus trying to employ, develop and activate each of them. This is why the assessment of Human Resources will reveal the competence profile of each staff member, both through performance evaluation and potential assessment.

Performance evaluation reports on the effectiveness and efficiency with which employees are doing their current job and training shortages which prevent them from doing so. On the other hand, potential assessment involves the assessment of development potential that employees have, both in their current position and in other possible jobs that they could have within the organization. This personal assessment helps to achieve different objectives:

1. Identify training needs of individuals so as to perform effectively, efficiently and/or safely at their current job.
2. Identify training needs so that employees with the right potential can be promoted to another position at the right time or change their functions within the same hierarchical level.
3. Complete data obtained from the job assessment in order to design the company's wage plans.

4. Use it as criterion for assessing the effectiveness of recruitment selection, training and promotion processes within the company.

Ultimately, managing people from a proactive perspective means understanding personal and professional development in a comprehensive way so that each staff member contributes to the development of the various areas and, consequently, of the organization as a whole (Gutiérrez, 2001).

In this way, a long history of job design research has shown that work structures influence the motivation, behaviour and well-being employees (e.g. Latham & Pinder, 2005; Morgeson & Campion, 2003; Parker & Ohly, 2008). As elaborated earlier, a proactive behaviour at work is a special type of motivations behaviour, which goes hand in hand with perceptions of control and capability. In this vein, the concepts of job autonomy, complexity and control, all concerned with the degree to which employees can choose how to proceed with their work, have been very consistently shown to be positively related with proactive behaviour (e.g. Frese et al, 2007; Morrison, 2006). For example, job autonomy has been positively linked with proactive behaviour such as personal initiative and idea implementation and problem solving (Bindl and Parker, 2010).

A proactive behaviour needs a work context that supports psychological autonomy; competence and relatedness enhance intrinsic motivation and increase well-being (Ryan and Frederick, 1997). According to Crant's (2000) integrative framework of the antecedents and consequences of proactive behaviour, two broad categories of antecedents can be identified: contextual (i.e. job resources, such as job control, feedback and variety) and individual factors (i.e. intrinsic motivations, such as physical demands, time pressure and shift work).

The presence of job resources stimulates personal development and increases work engagement; this is why it is important that the job design takes into account job resources such as performance feedback, job control, participation in decision making and social support (Salanova and Schaufeli, 2008). Work engagement refers to high levels of energy, persistence, identification and goal-directness; therefore, it can be expected that high levels of engagement increase proactive work behaviour, in the sense of personal initiative, because it is an indicator of intrinsic motivation at work. Indeed, individuals who feel a strong attachment to the organization were more likely to report suggesting and implementing initiatives to improve the organization (Strauss et al, 2009).

Also, job control is related to proactive behaviour; to exert control at work is intrinsically satisfying (Ryan & Deci, 2000) and makes additional engagement at work more likely (Hackman & Idham, 1976). Job control is necessary to translate feelings of activation into behaviour (Ohly & Fritz, 2010). Only if an individual has control over working methods can he or she react to feelings of activation by showing initiative – this enables employees to experiment in the workplace and thereby allow employees to generate and enhance creative ideas at work (Ohly et al, 2006).

In addition, leadership is other potentially important contextual influence on proactivity (Crant, 2000). Leaders at each level can motivate employee behaviour via different psychological processes (Chen & Bliese, 2002). Proactive behaviour can also be targeted toward change at different levels such as the individual task, the team and the organization (Griffin et al, 2007). Team member proactivity is aimed at changing the team situation and the way the team works. Organization member proactivity refers to individual behaviour that changes the way the organization works and is focused not only on work groups or departments but on the organization as a whole, going beyond organizational citizenship behaviour (Podsakoff et al, 2000).

Indeed, there are multiple types of proactive behaviours: proactive work behaviour, proactive strategic behaviour and proactive person-environment fit behaviour (Figure 2). These types are grown from the consideration that the definition of proactive behaviour as taking control of, and bringing about change within, the internal organizational environment, while proactive strategic behaviour is taking control of, and causing change in, the broader organization's strategy and its fit with the external environment. Finally, proactive person-environment fit behaviour is changing oneself or the situation to achieve greater compatibility between one's own attributes and the organizational environment (Parker & Collins, 2010).

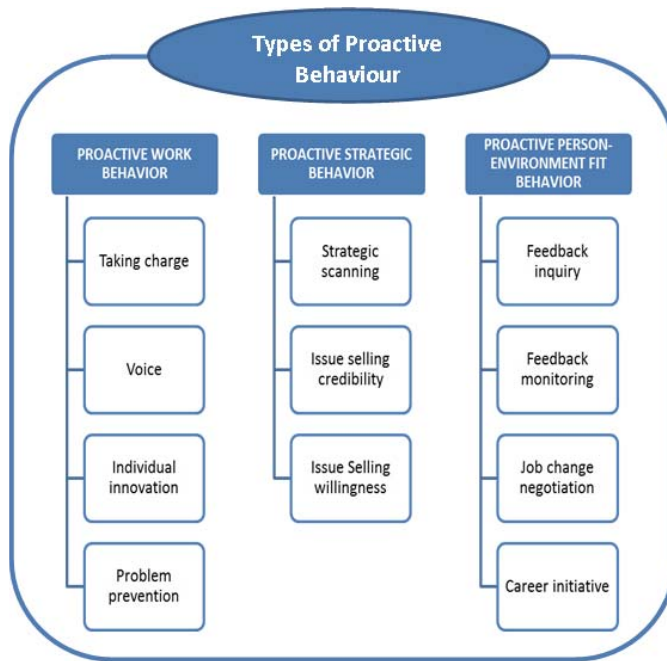
In this way, proactive work behaviour involves change in the internal organizational environment; some of the behaviours that can indicate that objective include the following:

- I. Taking Charge: Voluntary and constructive efforts to effect organizationally functional change with respect to how work is executed; change-oriented behaviour aimed at improvement (Morrison & Phelps, 1999). An illustrative behaviour of this is to try to bring about improved procedures in the workplace.

- II. Voice: Making innovative suggestions for change and recommending modifications to standard procedures even when others disagree; speaking up for something that is constructive and intended to positively contribute to the organization (Van Dyne & LePine, 1998). In this case, communicating one's views about work issues to others in the workplace, even if your views differ and others disagree.
- III. Individual Innovation: Behaviours involved in the creation and implementation of ideas (Scott & Bruce, 1994), including identifying an opportunity, generating new ideas or approaches, and implementing the new ideas.
- IV. Problem prevention: Self-directed and anticipatory action to prevent the reoccurrence of work problems (Frese & Fay, 2001). Involves trying to find the root cause of things that go wrong.

Similarly, changing the organization's fit with the external environment defines proactive strategic behaviour (Dutton & Ashford, 1993), which implies:

- I. Strategic Scanning: Proactively surveying the organization's environment to identify ways to ensure a fit between the organization and its environment, such as identifying ways the organization might respond to emerging markets or actively searching the environment for future organizational threats and opportunities.
- II. Issue Selling Credibility: Influencing the formation of a strategy in organizations by making others aware of particular issues (Dutton & Ashford, 1993); calling to an organization's attention key trends, developments and events that have implications for its performance (Morrison & Phelps, 1999).
- III. Issue Selling Willingness: Influencing the formation of a strategy in organizations by offering the time, energy and effort into ensuring key decision makers in the organization know the issues (Ashford, Rothbard, Piderit, & Dutton, 1998).



**FIGURE 2.** *Types of proactive behaviour (Adapted from Parker and Collins, 2010).*

Finally, proactive person-environment fit behaviour means changing oneself or the situation to achieve greater compatibility between one's own attributes and the organizational environment. In this case the behaviours that support this type of proactive behaviour are as follows:

- I. **Feedback Inquiry:** Directly asking for feedback from others; a type of proactive feedback seeking in which employees engage in voluntary and anticipatory actions to obtain information about their behaviour (Ashford & Black, 1996; Ashford, Blatt, & Van de Walle, 2003)
- II. **Feedback Monitoring:** Using as feedback the information obtained from actively monitoring the situation and others' behaviour (Ashford & Black, 1996; Ashford et al., 2003); this is considered a type of proactive feedback seeking.
- III. **Job Change Negotiation:** Explicit attempts to change one's job so that it better fits one's skills and abilities (Ashford & Black, 1996; Nicholson, 1984); a type of proactive socialization in which employees



actively adjust to new job conditions (Jones, 1986); originally applied to newcomers, though equally applicable to all employees.

- IV. Career Initiative: Individual's active attempts to promote his or her career rather than a passive response to the job situation as given (Seibert, Kraimer, & Crant, 2001); engaging in career planning, skill development and consultation with more senior personnel (Tharenou & Terry, 1998).

Actually, the staff can be proactive in one domain without being proactive in another, but when high levels of proactive works behaviour or proactive strategic behaviour are required, such as in the case of high level executives, one approach is to select individuals with particular dispositions, but another is to build individuals' role breadth via self-efficacy and felt responsibility for change. Both of these motivational states were considerable and strong predictors of these behaviours (Parker & Collins, 2010). Individuals who are engaging in proactive person-environment fit behaviour, which is perhaps the most visible, will also be proactive in improving the organization. On the other hand, learning goal orientation can predict several proactive behaviours, which is perhaps not surprising given the high degree of effort, persistence and recovery from setbacks that is required for proactive action.

In this way, Bateman and Crant (1993) developed the proactive personality concept, defining it as a relatively stable tendency to effect environmental change that differentiates people based on the extent to which they take action to influence their environments. Individuals with a prototypical proactive personality "identify opportunities and act on them, show initiative, take action, and persevere until meaningful change occurs" (Crant, 2000, p. 439). People with a proactive personality are relatively unconstrained by situational forces (Bateman & Crant, 1993), tend to set high standards, and harness all available resources into achieving those standards (Crant, 1996). Proactive personality captures the willingness and determination to pursue a course of action, characteristics that are central to models of self-development (Antonacopoulou, 2000).

Bateman and Crant (1993) validated a 17-item proactive personality scale, which investigates respondents' agreement to items such as "If I see something I don't like, I fix it." (Figure 3). Responses are made on a scale ranging from 1 (strongly disagree) to 7 (strongly agree). Higher scores indicate a proactive orientation.

The change-oriented and self-initiated focus of the proactive personality scale makes it highly relevant as an antecedent to specific proactive behaviours. Indeed, a vast number of findings confirm a consistently positive relationship between proactive personality and distinct proactive behaviours. To name a few, exemplary findings, proactive personality has been positively linked with network, proactive socialization into the organization (Kammeyer-Mueller & Wanberg, 2003) and career as well as various proactive work behaviours such as taking charge, individual innovation, problem prevention and voice.

Proactive Personality Scale from Bateman	
F1	I am constantly on the lookout for new ways to improve my life.
F2	I feel driven to make a difference in my community, and maybe the world.
F3	I tend to let others to let the others take the initiative to start new projects.
F4	Wherever I have been, I have been a powerful force for constructive change.
F5	I enjoy facing and overcoming obstacles to my ideas.
F6	Nothing is more exciting than seeing my ideas turn into reality.
F7	If I see something I don't like, I fix it.
F8	No matter the odds, if I believe in something I will make it happen.
F9	I love being a champion for my ideas, even against others opposition.
F10	I excel at identifying opportunities.
F11	I am always looking for better ways to do things
F12	If I believe in an idea, no obstacle will prevent me from making it happen.
F13	I love to challenge the status quo.
F14	When I have a problem, I tackle it head on.
F15	I am great at turning problems into opportunities.
F16	I can spot a good opportunity long before others can.
F17	If I see something in trouble, I help out in any way I can.

**FIGURE 3.** *Proactive personality Scale (Bateman and Crant, 1993: 112).*

This suggests two quite different strategies for obtaining a proactive workforce: recruiting individuals with a proactive personality and changing organizational practices to enhance the situation (e.g. work redesign), because personality variables have a positive influence on proactive behaviour. They affect perceptions of capability (role breadth self-efficacy), and they lead to broader and more flexible role orientations.

## 4.2 GENERATE PROACTIVE BEHAVIOUR AND STRATEGIC MANAGEMENT PROCESS

Proaction is like most other work behaviour: it is a function of both individual dispositions and the work environment. Thus, it can be harvested, grown and sustained via appropriate approaches to selecting, training, liberating and inspiring (Bateman & Crant, 1999), as described below.

- **Selecting and Training.** Individuals with a proclivity to engage in proactive behaviour may be identifiable among job applicants and current employees. Proaction can be assessed via a validated self-report measure, analysis of past achievements and appropriate interview questions. Behaviour questions – those that require applicants to describe actual experiences – may be especially useful. Applicants might be asked, “Tell me about a time you had an idea about how to improve things at work. What was the idea and what changes resulted?” Or, “Tell me about a time you encountered resistance to one of your ideas. What did you do?”

Next, training and development can enhance proaction. People can be asked to assess the extent of their proactive behaviour, and to think about and identify opportunities to be that way. Training can emphasize each of the elements of such behaviour as well as planning and commitment to proactive goals and activities. Also essential is the development of skills that both increase the probability of success in proactive initiatives and increase people’s confidence, or self-efficacy, in this domain. The skills would include problem finding, creativity, innovation, championing change and breakthrough thinking.

- **Liberating.** Proactive behaviour can arise naturally, of course, among individuals who are so inclined. Often, though, it is quashed. Actions that are inconsistent with corporate goals may be inappropriate, but it is striking how often potentially constructive

behaviour is squandered. Companies and managers can benefit simply from allowing more proactive behaviour to flourish.

To do this requires relaxing the over controlling tendencies of many company policies and structures. With the clear caveat that people throughout the firm should focus their energies on broad organizational goals, they can often be allowed more freedom to pursue those goals in fruitful, creative and innovative ways. The standard litany of bureaucratic constraints – rigid hierarchy, functional silos, centralized control, narrow job descriptions, cumbersome approval processes, tight-fisted resource allocation – have their purposes. But when they are too rigid, they constrain rather than liberate, and their disadvantages become serious.

Organizational formalities aside, the same point applies to over controlling styles of individual managers: autocratic decision making, demands for obedience and compliance, undue criticism, second guessing, punishments for mistakes, and a living-in-the-past, we've-always-done-it-this-way attitude. Perhaps most generally, heavy workloads and short-term pressures can prevent proactive behaviour from ever getting started. Relaxing unnecessary constraints – again, without throwing out necessary controls – can liberate essential proactive behaviour.

- **Inspiring.** Managers who want to inspire proactive behaviour will highlight its importance in the context of the broad organizational mission and agenda. The goal should be to have people throughout the firm committed to the strategic agenda and believing that proactive behaviour is an essential ingredient of success. Managers can take action consistent with their words, granting some freedom within the broader strategic parameters, and not punishing well-intended proactive efforts that do not work out. They will be proactive themselves, modelling the way for others.

Two key issues in motivating proaction entail how managers handle people's (1) ideas and (2) mistakes. When people propose ideas of uncertain merit, managers have response options of greatly varying impact. They can squash the ideas (and the people) on the spot, or they can ask questions to explore possibilities. They can veto ideas they think will not work, or they can allow people to try. Either strategically and with forethought, or more impulsively on the spur of the moment, managers make decisions about the amount of risk and uncertainty they will allow. Some will say "Try it" where others say "Better not." Thinking about yourself, how convinced of an idea's merit do you have to be before you would let someone try it?

Similarly, how managers respond to mistakes and failures will motivate – or fail to motivate – new initiatives. Some companies have a strong blame culture, in which finger-pointing and “cover your ass” are the norms, and even no-fault setbacks may be punished in ways subtle or unsubtle. In contrast, some managers and companies do not just give lip service to “learning from mistakes” – they actually do it, and even reward the effort, based on open discussion without stigma. The blame culture, of course, discourages proactive efforts, while the learning culture encourages them.

We stated earlier that proactive behaviour stems from individual dispositions and environmental conditions. People predisposed to proactive behaviour can be hired, trained in the necessary skills and liberated to act. But even for proactive individuals, ultimately their behaviour is like any other motivated behaviour: if it is rewarded, it will thrive. If it is punished, it won't – with the possible exception of a few hardy souls who keep trying, and who may end up leaving the firm if their efforts are consistently thwarted. To maintain people's motivation to work in a proactive mode, such behaviour can be incorporated into performance review systems. Bonuses, promotions and special awards can be based on criteria other than making the numbers – appropriate experimentation, initiative and perhaps even the good-faith failures that inevitably come from engaging in a variety of proactive efforts.

Thus, in a context of a Strategic Management Process, to generate proactive behaviour, it is necessary to motivate the three aspects of proactive behaviour: self-starting, proactive personality, and overcoming barriers (Table 4) in each stage of the strategy (Frese and Fay, 2001).

The strategic process, in this case, has the following stages: a goal development, collecting information and prognosis, plan development and execution, monitoring of the execution of a plan, and feedback. Once a goal is established, a person looks for information and, when dealing with dynamic systems, makes some kind of a prognosis of future states. The information is used to develop plans that are then executed. During plan execution, actions are monitored. The person gathers feedback that is used to adjust his or her actions. The three aspects of proactive behaviour must be present in each strategic phase to activate a proactive strategy in the organization:

1. Self-starting implies that goals, information collection, planning and feedback processes are active.

- a. Goals. Actions are goal-oriented and guided by goals. At work, goals are determined by the tasks required. There is a translation process from the organizational task descriptions into goals – the redefinition process (Hacker, 1998; Hackman, 1970). For instance, the employee decided that, as a company member, he/she needed to do something to improve the web image of her company. Thus, he/she developed a task for him/herself that was not part of his/her job description, but that was useful because it advanced the market chances of the company.

The redefinition process makes it possible to define extra-role goals; that is, goals requiring a self-starting approach and thus proactive behaviour. The redefinition process is the starting point for proactive behaviour. We assume that in every job, it is possible to add on or to revise goals in the process of redefinition (see Staw & Boettger, 1990). This is true even for assembly line work. Quality issues, thinking about new ideas on how to do the work, discussing problems with materials or parts used as input into the assembly line and their quality with colleagues – all these factors are part of the redefinition of tasks even on an assembly line.

A goal may be a specific goal (“I want to write a letter”) or it may be a meta-goal (“I always want to be on good terms with my colleagues”). A meta-goal is a goal that regulates the setting of one’s goals (we define a meta-goal similarly to a meta-cognition, see Frese, Stewart, & Hannover, 1987; Weinert & Kluwe, 1987). The most important meta-goals for Proactive Behaviour are active meta-goals. We assume that people differ on the dimension of active versus passive meta-goals. An active meta-goal implies being active even when one does not gain rewards from this activity; for example, a temporary worker might start to develop ideas on improvements even though he or she is on the job for only a few days. People with a meta-cognitive tendency toward active goals will show more Proactive Behaviour.

- b. Information collection and prognosis implies that one gets to know the environment so that one can act within it. Information collection and prognosis may be active or reactive. An active information search scans the environment for potentially important cues. Since action opportunities are often hidden and unobtrusive, self-started exploration makes it more likely to find these opportunities. Some type of prognosis is necessary when the environment is dynamic and changes without input from the actor (Dörner, 1996). An

active search is particularly important when the environment is not transparent (e.g. a complex technical system, the economy of a country or the actions of other humans, Dörner, 1996).

- c. Plan and Execution. An active plan goes beyond the normal and “obvious” plan of action. Analyses of research and development work have shown that the most frequent choice is some combination of planning and opportunistic approaches. This essentially means that bouts of planning are interspersed with opportunistic procedures (Hacker, 1999; Sonnentag, 1998).
  - d. Monitoring and Feedback implies that a person develops his or her own checks and feedback. For example when developing new software, it is useful to develop checks and feedback so that one can tell whether one is on the right track during the course of programming. Active feedback seeking by new employees has also been shown to relate to higher performance (Ashford & Black, 1996; Morrison, 1993).
2. Proactive personality implies that each step of the action sequence relates to dealing with future problems and opportunities.
- a. Goals imply that people take a long-term approach to work. The literature on economic strategies argues forcefully that detecting future opportunities is the key to business success (Hamel & Prahalad, 1994) and, indeed, those companies with managers who scan the environment more actively are more successful (Daft, Sormunen, & Parks, 1988). A long-range perspective also helps to look for information in order to understand potential problem areas and opportunities.
  - b. Information collection and prognosis is seen when a person deliberately searches for problem areas and barriers, and looks for alternative routes and strategies before the problems appear. Similarly, information is collected in order to know future opportunities.
  - c. Plan and execution. Plans imply that a person develops back-up plans (Plan B) in case something goes wrong. This also applies to plans for dealing with opportunities. Again, it is helpful to have a long-term orientation when developing proactive plans and to think about the long-term implications of such a plan.



- d. Monitoring and feedback means that people develop pre-signals. These are signals that tell the actor in time that problems (or opportunities) will occur in the future. A proactive stance implies that pre-signals for potential problems (and opportunities) are developed. When barriers are anticipated from such pre-signals, they can be detected and dealt with more quickly or even prevented
3. Overcoming barriers implies that goals, information collection, plans and feedback are protected against interference.
    - a. Goals. People have to protect their goals. They have to convince themselves that it is worth continuing with a certain self-started action even when it is not immediately successful. One prerequisite for continuing with a path of action in spite of problems is a feeling of responsibility for the process and the outcome. If people negate their responsibility by attributing it to others (“it was his fault that we could not meet the deadline”), there is little impetus to overcome barriers.
    - b. Information collection and prognosis can also be interrupted by negative emotions as well as the complexity of the environment one is dealing with. Protecting oneself from giving up one’s search activities in spite of complexity and negative emotions is an important element for overcoming barriers in this step of the action sequence. As a matter of fact, one frequent mistake is to halt one’s search activity prematurely and stick to the first solution that comes to mind (Dörner & Schaub, 1994) when familiarising oneself thoroughly with a complex situation seems to be too laborious.
    - c. Plan and execution. Plans are developed and put into effect, and barriers on the path to success must be overcome. Typically, these are barriers that block a plan of action. Back-up plans help here because they are essentially contingency plans in case a barrier should appear. Plans also need to be protected against disturbances. Fascinating new data on expertise in the work setting show that one of the best predictors of competence in software developers is the speed with which they return to their plan of action after having been disturbed (Sonnetag, 1998). On the other hand, it is useless to stick to a plan that is obviously not working. Volpert (1974) argued that effective action is stable in goals and flexible in plans. This implies that protecting plans is less important than protecting goals during the flow of action.



- d. Monitoring and feedback phase of the action sequence is related to protecting the feedback search from difficulties that may arise. A situation may be so complex that it is difficult to construct feedback signals. Also, it may be hard to search for feedback because the situation lacks transparency or questions are prohibited.

As a summary in Table 4, it is visible that the strategic process to develop an enterprise is soaked in proactive behaviour in each of its phases in regard to the development of the three dimensions that integrates proactive behaviour.

**TABLE 4.** *The strategic process to develop an enterprise.*

<b>Action Sequence</b>	<b>Self-starting</b>	<b>Proactive personality</b>	<b>Overcome Barriers</b>
<b>Goals/redefinition tasks</b>	Active goal, redefinition	Anticipate future problems and opportunities and covert into a goal	Protect goals when frustrated or taxed complexity
<b>Information collection and prognosis</b>	Active research, i.e. exploring, active scanning	Consider potential problem areas and opportunities before they occur  Develop knowledge on alternatives routes of action	Maintain search in spite of complexity and negative emotions
<b>Plan and execution</b>	Active plan	Back-up  Have action plans ready for opportunities	Overcome barriers  Return to plan quickly when disturbed
<b>Monitoring and feedback</b>	Self-developed feedback and active search for feedback	Develop pre-signals for potentials problems and opportunities	Protect feedback search

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# **V** GLOSSARY FOR THE PROACTIVE LAW APPROACH

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## DELIMITATION OF THE GLOSSARY

This glossary has been limited to cover only the most important concepts pertaining to the proactive approach to law, and especially those that occur frequently in this PAM PAL Handbook, so that the users of the handbook will understand the meaning of the concepts as they have been understood and used by the members of the PAM PAL project and the authors of the handbook.

### Principle

A standard that is to be observed, not because it will advance or secure an economic political or social situation deemed desirable, but because it is a requirement of justice or fairness or some other dimension of morality (Dworkin 1977, 90)

### Law

A body of rules, principles, morals, objectives, practices and processes. (cf. Salmond 1924, 39, 61-63 and 1966; Tolonen 1991; Salmi-Tolonen 2011)

### Rule

A provision enacted by the legislator that imposes duties, confers rights or creates competences.

### Regulation

A process of goal-oriented controlling, governing or directing.

### Private regulation

A body of rules, practices and processes, created primarily by private actors either exercising autonomous regulatory power or implementing delegated power conferred by international law or by national legislation. (Cafaggi 2011, 20–21)

## Self-regulation

Regulation of an industry by its own members, usually by means of a committee that issues guidance and sets standards that it then enforces.

## Private rule-making

An activity where private actors, such as firms, non-governmental organizations, independent experts or epistemic communities produce rules.

## Private law

Publicly (mainly state-) produced law, including mandatory and enabling provisions, which individual or collective private actors can specify and modify, when rules are enabling. (Cafaggi 2011b, 93).

## Proactive

Being proactive implies acting in anticipation, taking control and self-initiation.

## Proactive law

A comprehensive concept concerning civil and commercial matters which refers to any regulation measure/activity, undertaken by public or private actors, as well as its methods, instruments and results, whose purpose is by imposing duties, conferring rights and creating competences enable and empower individuals concerned, or private or public bodies, in achieving their commonly defined goals. In practice, the forms this concept takes are rules, practices and/or processes (Salmi-Tolonen 2011).

## Proactive contracting

Activity where the principles of proactive law are applied to contracting; e.g. acting in anticipation, and taking advantage of all the possibilities regulation gives to enable success in planning, supporting and sustaining a contractual relationship. It is a collaborative cross-professional process to enable success



ex ante. It helps parties to reach their business goals by developing proper understanding, structures, rules, procedures as well as tools and aims at identifying possible sources of disagreements and problems by bringing them out to the open before they cause damage.

### **Proactive lawyering**

Applying proactive law principles in legal practice; client counselling, assisting clients in achieving their lawful purposes with the least risk of avoidable legal trouble and using all the possibilities regulation gives to enable clients to succeed in their endeavours.

### **Preventive law**

Law dedicated to preventing legal risks from becoming legal problems. The “father” of this approach was Professor Luis M. Brown who founded the National Center for Preventive Law in the US and applied its principles in teaching law.

### **Preventive lawyering**

Preventive law in legal practice; client counselling, assisting clients in achieving their lawful purposes with the least risk of avoidable legal trouble. (National Center for Preventive Law) The three phases of preventive lawyering are: keeping the problem from arising, interrupting the cause and effect, palliating and minimising the damage. (Dauer 2008, 25)

### **Collaborative law**

A method of practicing law where the parties and the lawyers representing them sign a contract in which they agree towards a settlement. In this method, the attorneys must focus on settlement and are free to use their creative problem solving skills, and the process is future-focused. The method is most often used in the domestic area, but is suitable for many types of law in civil context. <[resurgence.opendemocracy.net/index.php](http://resurgence.opendemocracy.net/index.php)>

## Comprehensive law

A term coined by professor Susan Daicoff, referring to a movement that utilizes the insights of procedural justice and other social science-based understanding of the intrapersonal and interpersonal dynamics of legal affairs and legal disputes. Problem solving courts in the US, which include drug treatment courts, unified family courts and mental health courts, are examples of the comprehensive law movement in application. <[resurgence.opendemocracy.net/index.php](http://resurgence.opendemocracy.net/index.php)>

## Value chain

The sequence of activities required to make a product or provide a service (Schmitz 2005, 4).

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