Petri Mäntysaari

Organising the Firm

Theories of Commercial Law, Corporate Governance and Corporate Law

Springer

Chapter 8
Self-enforcing Governance Models

8.1 Introduction: Corporate Governance and Organisational Design

The legal corporate governance theory proposed in Chap. 7 explains what issues must be managed in some way or another, and for what purpose they should be managed. However, it does not explain how exactly they should be managed. How should one organise the firm?

Organisational design. There are many models for organisational design. The answer can depend on the choice between generality or detail, and on the issues that are regarded as relevant.

For example, Aoki and Jackson (2008) study organisational architecture at a very high level of generality. They identify four models on the basis of equilibrium modes of linkage between the basic stakeholders' assets (managers' human assets, workers' human assets, and investor-supplied physical or financial assets). The four models are: (1) property-rights-based control of organisational hierarchies (the traditional US/UK model); (2) co-determination and workers' participation in work-site control (German); (3) relational contingent governance of the team-like organisational architecture (Japanese); and (4) the venture capitalist governance of tournament among entrepreneurial start-up firms (Silicon Valley).[1] According to Aoki and Jackson, the performance of any governance model or mode of organisational architecture may be relative. History matters (path dependency), and a model may not be absolutely superior to other models independently of the nature of markets, technology, social values, political economy features, and other circumstances.[2]

[1] Aoki M, Jackson G, Understanding an emergent diversity of corporate governance and organizational architecture: an essentiality-based analysis, Ind Corp Change 17 (2008) pp 2–3 and 11.

[2] *Ibid*, pp 10–11.

P. Mäntysaari, *Organising the Firm*,
DOI 10.1007/978-3-642-22197-2_8, © Springer-Verlag Berlin Heidelberg 2012

Focusing more on corporate units, it is customary to distinguish between the "unitary corporation" (U-form corporation) and the "multidivisional corporation" (M-form corporation, Sect. 9.4.6). U-form corporations are organised into functional departments such as sales or manufacturing. M-form corporations have operating units organised as divisions (Chandler 1962, 1977, 1991, Williamson 1975).[3]

Alternatively, one could use organisational design principles that enable firms to choose more detailed governance models. There are some widely-used organisational design frameworks.

One of them is Galbraith's Star Model which identifies five design policies and five basic structures.[4] (a) In the Star Model, design policies fall into five categories. *Strategy* determines direction and establishes the criteria for choosing among alternative organisational forms. *Structure* determines the location of decision-making power in the organisation. *Processes* determine the functioning of the organisation and address the flow of information. *Rewards* and reward systems align the goals of employees with organisational goals. *People* policies or human resources policies are designed to influence the employees' mind-sets and skills.[5] (b) Five basic structures can be derived from such strategies: (1) the *functional* structure (organised around activities or functions, also known as the U-form); (2) the *product* structure (also known as the M-form); (3) the *market* structure (organised around customers or markets); (4) the *geographical* structure; and (5) the *process* structure (organised around a complete flow of work).

There are also other design models. According to Booz-Allen & Hamilton's Natural Business Unit (NBU) model, the customer perspective should serve as the starting point. Firms should be built around capabilities required for satisfying customer needs. Once such specific business needs are defined, the firm should create a structure that serves them. When applied in its purest form, the NBU model means that each NBU is structured and managed as if it were an independent entity with outsourced services.[6]

---

[3] See Chandler AD, The Visible Hand: The Managerial Revolution in American Business. Belknap Press, Cambridge, Mass. (1977) pp 5–12; Williamson OE, Markets and Hierarchies: Analysis and Antitrust Implications. The Free Press, New York (1975) pp 135–138; Williamson OE, The Economic Institutions of Capitalism. The Free Press, New York (1985) pp 289 and 320; Bainbridge S, Director Primacy: The Means and Ends of Corporate Governance, Northw U L Rev 97 (2003) pp 547–606 at 566–567.

[4] Galbraith JR, Organization Design. Addison-Wesley, Reading, Mass. (1977); Galbraith J, Designing Organizations: An Executive Briefing on Strategy, Structure, and Process. Jossey-Bass Inc., San Francisco, Calif. (1995).

[5] Compare Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 16, 30; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 165–174.

[6] Jones J, Keller S, Neilson G, Spiegel E, Organizing for Agility: Creating Natural Business Units. Booz-Allen & Hamilton, USA (1999).

Goold and Campbell (2002) present nine tests that can be used to either evaluate an existing organisation design or create a new one. (a) Four "fit" tests are used for screening (the market advantage test, the parenting advantage test, the people test, and the feasibility test). (b) Five "good design" tests can help the firm to refine its organisational design (the specialist cultures test, the difficult links test, the redundant hierarchy test, the accountability test, and the flexibility test).[7]

Self-enforcement. A different approach is chosen in this book. This chapter focuses on self-enforcement as one of the key issues that influence the governance structure of firms.[8] The next chapter suggests that governance models are not sustainable unless they also foster innovation. Both chapters try to explain why firms are organised the way they are organised. For example, management authority tends to be vested in a management body and monitoring authority in a monitoring body, because the separation of management and monitoring is one of the core components of the self-enforcing governance model. Moreover, corporate law tries to facilitate the use of self-enforcing governance models, because it would be very expensive and contrary to the interests of firms to use the court or the government as a monitoring or control device on a large scale.

A governance model is here defined as self-enforcing when it requires little external monitoring inputs in addition to (1) the inputs of customers and contract parties, and (2) the enforcement of general laws.[9]

There are two main elements in self-enforcing corporate governance models, the delegation of power and the concentration of power. Both give rise to characteristic problems in addition to general agency problems. When power is delegated, there is a coordination problem. When power is concentrated, problems can relate to bureaucracy and constraints on innovation. For this reason, these two seemingly contradictory elements must be combined.

Self-enforcing governance models are used by various kinds of organisations ranging from large industrial firms to law firms, and from co-operatives to NGOs and terrorist organisations. We will study self-enforcing governance models in the light of illustrative examples and previous theories. The previous theories that will

[7] Goold M, Campbell A, Do You Have a Well-Designed Organization? HBR 80(2) (2002) pp 117–124.

[8] For self-enforcement and the equilibrium state, see Aoki M, Toward a Comparative Institutional Analysis. The MIT Press, Cambridge, Mass. (2001) pp 6–9 and 15 (discussing Hurwitz 1993, 1996). See also Aoki (2001) p 281: "... a corporate governance mechanism is a set of self-enforceable rules (formal or informal) that regulates the contingent action choices of the stakeholders ... in the corporate organization domain".

[9] Compare Greif A, Commitment, coercion, and markets: The nature and dynamics of institutions supporting exchange. In: Menard C, Shirley MM (eds), Handbook of New Institutional Economics. Springer, Dordrecht (2005) pp 756–757: "Self-governance entails having bodies of collective decision-making, mechanisms, such as judicial processes and police forces, to overcome the free-rider problem and motivate and induce members to participate in sanctions."

help to understand self-enforcing models include Ostrom (1990) and Black and Kraakman (1996).[10]

Four basic types of self-enforcing models can be distinguished on the basis of the examples and theories: the model based on the delegation of power; the model based on the concentration of power; the Ostrom model; and the model that fosters innovation. Self-enforcing corporate governance models should contain elements of all four models.

8.2 The Problem

Why should the firm choose a self-enforcing model? Let us assume that the firm is the principal. In this case, external monitors can be regarded as the firm's agents. The firm will thus incur agency costs.[11] No agency costs for external monitoring will be incurred to the extent that no external monitors are required (no agency). This can mean savings. For example, if shareholders as a class are not an important provider of monitoring services, other ancillary services, or funding, the firm will not need to distribute as much funds to shareholders or to use funds to maintain a high share price.

Alternatively, one can assume that investors as a class are the principal. Board members and managers can then be regarded as their agents. If the governance model is self-enforcing, investors do not have to monitor the firm to the same extent. This means savings for them. For example, shareholders of a large listed company with a dispersed share ownership structure customarily do not want to invest time and money in monitoring. Savings can increase the price that investors are prepared to pay for securities issued by the firm and reduce the firm's funding costs.

The firm can thus benefit from a self-enforcing corporate governance model. In the long run, it can increase the firm's survival chances. This is reflected in corporate law. Separate legal personality, the existence of shareholders with transferable shares, the limited liability of shareholders, and the existence of corporate organs responsible for monitoring and management achieve two things. First, they reduce shareholders' risks and their need to monitor the firm. Second, they make the people that belong the organisation of the firm responsible for monitoring and management and give them incentives to do so. Many of the fundamental characteristics of corporations are thus designed to facilitate self-enforcement.

Now, the self-enforcing model relies on internal agents rather than external ones. This is what makes it *self*-enforcing. But reliance on internal agents gives rise to characteristic problem areas:

---

[10] Ostrom E, Governing the Commons: The Evolution of Institutions for Collective Action. Cambridge U P, Cambridge (1990); Black B, Kraakman R, A Self-Enforcing Model of Corporate Law, Harv L Rev 109 (1996) pp 1911–1982.

[11] Jensen MC, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) pp 308–309.

1. Management of internal agency relationships. This is the key problem area, since most of the target-setting and monitoring is, by definition, done internally, that is, by members of the organisation.
2. Target-setting. Even target-setting must be done internally. This creates problems, because the organisation's members may have incentives to further their own personal interests rather than the interests of the organisation (the firm) when setting the targets.
3. Monitoring. By definition, there should be minimal reliance on external monitors. But this increases the problem of who monitors the monitors.
4. Coordination. The model is not sustainable, unless it enables sufficient coordination of activities. But there can be too little coordination, as members of the organisation may prefer more discretion. There can also be too much bureaucracy, as the lack of external monitors means that internal bodies will need to be created to solve the problem of who monitors the monitors.
5. The role of mandatory laws. Laws can be used to influence behaviour. Many corporate governance models require the existence of laws in general (for example, company laws that facilitate the existence of companies), and mandatory laws in particular (for example, much of the German Aktiengesetz, the UK Listing Rules, and the US Sarbanes-Oxley Act). However, the enforcement of external legal norms can be time-consuming and expensive, and, as one cannot be sure of the outcome, combined with exposure to legal risk. The rule of law is not always enforced to the benefit of the firm, and it is not enforced in most countries of the world.

The self-enforcing model should therefore deal with such issues. The model should: work with minimal resort to legal authority, including the courts; work with minimal resort to other external monitoring inputs; reduce internal agency problems; enable the effective coordination of activities; and be sustainable. We can now study how these issues might be dealt with.

8.3 Delegation of Power

The first model could be to give members of the organisation plenty of discretion by delegating power to them. However, when participants in the self-enforcing model have plenty of discretion, there is a coordination problem. This model can be illustrated with the al-Qaeda case.

The al-Qaeda case. The loose network known as al-Qaeda is notorious but secretive. We can assume that the following aspects are characteristic of al-Qaeda and its governance model:

1. It exists outside the law (in the sense that it is illegal and states try to kill or capture its members) but not completely outside the general legal system (it tries

to benefit from laws, such as company laws, banking laws, human rights laws, and so forth).[12]
2. It consists of a number of local cells that largely act independently (the capture or killing of members will not endanger the whole network).
3. Information flows are restricted (for security reasons, see number 2).
4. Members of the organisation share a common culture.
5. There is a training camp for future terrorists.
6. Future terrorists are recruited by reliable local representatives from a pool of locally known fanatics (information management is important, because wrong recruitment choices may endanger the whole network, see number 1).
7. There is a reliable moneyman controlling centralised funding (Osama Bin Laden was a wealthy businessman that controlled funding, among other things).
8. The network needs donations.

The most obvious problems here are: coordination (numbers 1–3); and insufficient protection by laws (number 1). In other words, how can you coordinate anything if information flows are restricted (if states get to know the whereabouts of al-Qaeda's members, the members might be killed) and the cells must act independently?

The main ways to deal with this problem are: reliance on a strong *culture*; careful *recruitment*; centralised *training*; and centralised *funding*. (a) Members of al-Qaeda tend to be highly committed to the network's goals. The network would not exist unless all its members shared the common culture and were committed to its cause. (b) It is vital not to employ wrong people in the first place. Careful recruitment is supported by the screening of members locally and at the training site. (c) It is customary for members of the organisation to learn the trade in a standardised way. This can also contribute to the network's common culture. (d) Centralised funding is a powerful instrument as it is difficult for local cells to raise funding openly.

Like all self-enforcing models, even this model is complemented by monitoring by *customers* and the market. In this case, donors can be regarded as customers. Al-Qaeda is not an exception from the rule that all organisations need funding. In addition, al-Qaeda would not survive without business partners that provide valuable services.

8.4 Centralisation of Power

The opposite of delegation of power is centralisation of power. In this case, coordination is not the problem. There are two kinds of characteristic problems.

[12] For example, a basic level of law and order may be necessary for pirates to ply their trade. De Groot OJ, Rablen MD, Shortland A, Gov-aargh-nance – "even criminals need law and order", CEDI Discussion Paper Series 11–01, Centre for Economic Development and Institutions, Brunel University (February 2011).

First, it can be difficult to monitor the monitors and manage internal agency relationships. The reason is that all monitoring must be taken care of internally. By definition, you try not to rely on external monitors in the self-enforcing model.

The customary ways to manage these problems include, in particular: *separation* of functions (initiation of decisions, ratification of decisions, execution of decisions); *mutual monitoring* (boards, the participation of many people in the decision process and monitoring); *mixed monitoring* (different classes of monitors participate in the monitoring process); and a *common goal*.

Second, centralisation of power can increase bureaucracy and reduce innovation. Both can make it more difficult for the firm to adapt and survive in the long term. The ways to address this problem will be discussed in Chap. 9.

This model can be illustrated with the governance model of large listed German companies (AG) and the Black and Kraakman model. We can start with the latter.

The Black and Kraakman model. The Black and Kraakman (1996) model[13] was intended for emerging capitalist economies that still lacked strong institutional, market, cultural, and legal constraints on the governance of companies. The purpose of this model is to allow large "outside shareholders" to protect themselves from insider opportunism with minimal resort to legal authority, including the courts.

The central features of the Black and Kraakman self-enforcing model of corporate law are:

- Enforcement, as much as possible, through actions by direct participants in the corporate enterprise
- Greater protection of outside shareholders than is common in developed economies
- Reliance on procedural protections
- Use of bright-line rules rather than standards
- Strong legal remedies on paper, to compensate for the low probability that the sanctions will be applied in fact

As the Black and Kraakman model is a model for the protection of "outside shareholders", self-enforcement takes place "primarily through a combination of voting rules and transactional rights". Transactional rights include pre-emptive rights, appraisal rights, and sell-out rights. The central voting elements include, for example, shareholder approval for broad classes of major transactions and self-interested transactions, and approval of self-interested transactions by a majority of outside directors.

The Black and Kraakman model thus focuses on the management of the relationships between minority or outside shareholders and corporate insiders. Black and Kraakman chose outside shareholders as the principal. The most

[13] Black B, Kraakman R, A Self-Enforcing Model of Corporate Law, Harv L Rev 109 (1996) pp 1911–1982.

important way to manage this relationship is by regulating the scope of agency:[14] the right to decide on important issues is vested in shareholders or outside shareholders rather than corporate insiders.

The Black and Kraakman model seems to contain some elements of continental European and EU company law without going as far as the governance model of large German companies (see below).[15] Unlike the German corporate governance model, the Black and Kraakman model:

- Requires the active participation of shareholders
- Does not clearly separate decision management and decision control (initiation of decisions, ratification of decisions, execution of decisions)
- Relies less on mutual monitoring and mixed monitoring
- Does not rely on a favourable societal and corporate culture and
- Tries to replace the absence of a favourable corporate culture with legal rules

As a result, this model is less self-enforcing than the German corporate governance model designed to work even without minority shareholders' active monitoring inputs. Overreliance on legal rules is also bound to cause problems in a society that does not enforce the rule of law.

The German model. Like all corporate governance models, the German model is embedded in an institutional environment that consists of several complementary institutions. Before studying the German model, it is therefore useful to keep in mind the differences between the German and UK markets. Germany and the UK have:

- Traditionally different approaches to regulation (mandatory regulation through laws in Germany, industry self-regulation in the UK)
- Different industries (manufacturing is more important in Germany, financial services are more important in the UK)
- Different corporate governance cultures (the interests of the firm prevail in Germany, shareholder primacy prevails in the UK)
- Different share ownership structures (it is customary to have a controlling shareholder in Germany, share ownership is more dispersed in the UK)
- Different roles for banks (it used to be customary for firms to have a close long-term relationship with a "house bank" in Germany, banks do not have such a relationship with their customers in the UK)
- Different approaches to self-enforcement (it is characteristic of German corporate governance, it is less important in the UK)

The following aspects are characteristic of the governance model of a German AG:

[14] See Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 105.

[15] See also Bebchuk LA, The Case for Increasing Shareholder Power, Harv L Rev 118 (2005) pp 833–914.

1. The governance model of the AG is facilitated by the largely mandatory provisions of the Aktiengesetz (AktG).
2. There is statutory separation of powers and mixed monitoring.
3. The AG has a supervisory board that is responsible for monitoring but must not manage.
4. The AG has a management board that must manage the firm.
5. All members of the management board are executives.
6. The supervisory board and the management board have no common members.
7. Members of the management board and supervisory board have a duty to act in the interests of the firm (Unternehmensintresse).
8. Up to half of members of the supervisory board are employee representatives (co-determination).
9. The AG often has a controlling shareholder.
10. The AG often has a "house bank" (Hausbank).
11. Even small shareholders have relatively extensive legal rights.

The German model is thus a combination of several mutually consistent institutional arrangements.[16]

It is an example of *mixed monitoring* (or "shared control"[17]). The core of the mixed monitoring system is the two-tier board. Mixed monitoring is increased by the existence of other monitors. The most important of them is the controlling shareholder. A controlling shareholder has both legal and de facto powers. Employees have influence through members of the supervisory board. Moreover, the house bank can have de facto powers as a provider of funding, as an adviser, or in some cases through its representative in the supervisory board.

This model is also an example of *mutual monitoring* since both the management board and the supervisory board are collegiate organs consisting of many members.

In order to work, the mixed monitoring system requires *clear rules* on the allocation of power, the separation of functions, and the corporate objective. The most important rules are set out in the AktG. The AktG lays down detailed and mandatory rules on the separation of functions. The AktG was originally designed for large companies with a dispersed share ownership structure,[18] and the purpose of its many mandatory provisions is to reduce shareholders' need to monitor the

[16] See Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) pp 239–242; Aoki M, *op cit*, p 17; Aoki M, Jackson G, *op cit*, p 7: ". . . corporatism, co-determination and the Hausbank system in the traditional German model may be considered as constituting an institutionally complementary cluster, while another cluster may include stock market control, hierarchically ordered [human assets], and the liberal state".

[17] Tirole J, Corporate Governance, Econometrica 69 (2001) pp 28–29.

[18] See Cheffins BR, Mergers and Corporate Ownership Structure: The United States and Germany at the Turn of the 20th Century, Am J Comp L 51 (2003) pp 473–503.

monitors and the management.[19] For example, all members of corporate bodies must further *the interests of the firm* (Sect. 6.3).[20]

The German model is embedded in German societal and business culture. The model relies on compliance and forces corporate bodies to cooperate and seek consensus. (a) This can perhaps make decision-making slower and reduce the organisation's agility and ability to adapt to changes in circumstances. Moreover, the large number of participants with potentially conflicting interests may increase agency costs. (b) On the other hand, increasing the number of participants in the decision-making process can mean that decisions are based on better information and that the participants are more committed. Agency costs can be reduced by a strong culture. The participation of employees and banks can reduce excessive risk-taking. In the light of the strength of the German manufacturing industry, this governance model seems to bring benefits at least in business sectors that require long-term investment and long-term commitment to innovation and quality.[21]

The German model seems to comply with many of the principles of the self-enforcing model (see above) although it is largely based on mandatory law and the existence of a compliance culture. One may ask whether it would be possible to design a self-enforcing model that does not rely on external rules to the same extent. We will study this question in the next section.

8.5 Delegation and Centralisation

Both the al-Qaeda case and the German corporate governance model indicate that you cannot design a self-enforcing model without combining the delegation and centralisation of power. A combination is necessary in order to mitigate inherent problems. The question is how delegation and centralisation should be combined.

Obviously, the answer can depend on the circumstances and the firm. We can study two earlier attempts to solve this problem. The first is the Ostrom model. The second is a model used by a Finnish group of co-operatives. We will discuss this question even in Sect. 8.6 and Chap. 9.

The Ostrom model. Elinor Ostrom's self-enforcing model is based on a combination of centralisation and delegation. Ostrom (1990) studies the "tragedy of the commons" or common property rights (CPR). Ostrom points out that "analyses in modern resource economics conclude that where a number of users have access to a common-pool resource, the total of resource units withdrawn from the resources

[19] See Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005) p 389; Aoki M, *op cit*, p 290: "When control rights are shared with the worker, more external financing will be made in the form of long-term debt contracts."

[20] § 93(1) AktG; § 116 AktG; § 242 BGB; BGHZ 65, 15 (ITT).

[21] For a hostile view on co-determination, see, nevertheless, Bainbridge S, The New Corporate Governance in Theory and Practice. OUP, Oxford (2008) pp 45–49.

will be greater than the optimal economic level of withdrawal".[22] Simply put, the problem is that "everybody's property is nobody's property". There used to be two traditional solutions to the problem. One could either add a central authority such as the state to regulate and manage the resource, or make the resource "somebody's property" through private property rights. Ostrom proposes a third solution.

Ostrom's solution is to use a self-enforcing model that consists of five design principles and rules that:

- Define a set of "appropriators" who are authorised to use a CPR (design principle 1)
- Relate to the specific attributes of the CPR and the community of appropriators using the CPR (design principle 2)
- Are designed, at least in part, by local appropriators (design principle 3)
- Are monitored by individuals accountable to local appropriators (design principle 4) and
- Are sanctioned using graduated punishments (design principle 5)[23]

For example, one could try to apply Ostrom's theory to professional firms such as law firms:[24]

- Choice of resources. One could study the use of the common resources of a law firm.
- Appropriators. Partners could be chosen as appropriators (design principle 1).
- Attributes. The rules on the use of the resources should make sense for law firms in general and the firm's partners in particular (design principle 2).
- Design. In this case, the rules should be designed by the partners (design principle 3).
- Monitoring. The rules and compliance should be monitored by people and bodies elected by the partners, for example by committees and a partner that acts as a CEO (design principle 4).
- Sanctions. The sanctions for non-compliance could range from a friendly discussion to the application of rules on exit (design principle 5).

But there are limits to Ostrom's theory. First, it is designed for certain types of CPR. Ostrom studies renewable rather than non-renewable resources. Second, she studies situations in which users must rely on the CPR for their living and have no other choice. As a result, users of the CPR can substantially cause each other harm. However, the firm's employees and managers do have a choice and it is customary for them to move from one firm to another. Because of the freedom to exit the firm, members of the "team" are less likely to be able to cause each other harm and less dependent on the CPR. Third, although Ostrom explains that certain things should

[22] Ostrom E, Governing the Commons. Cambridge U P, Cambridge (1990) p 3.

[23] *Ibid*, pp 185–186.

[24] *Ibid*, p 25: "Examples of self-organized enterprises abound. Most law firms are obvious examples . . . Most cooperatives are also examples."

be coordinated by the users, she does not explain how coordination (rule-making, monitoring, execution of decisions, and enforcement of sanctions) should be organised. Fourth, as a large increase in the number of users makes it more difficult to coordinate things, it may be unclear to what extent Ostrom's model would scale up. For example, Ostrom's model can perhaps be applied to a middle-sized law firm, but can it be applied to a large industrial firm (or to global resources such as the atmosphere)?

One can therefore say that Ostrom's model focuses more on delegation than on centralisation or coordination. If one wants to design a self-enforcing model for a large firm, one should therefore complement Ostrom's model with the coordination approach or the German model (Sect. 8.4). On the other hand, Ostrom mentions cooperatives as an example of "self-organized enterprises". We can study whether this can be done in a cooperative.

A group of Finnish cooperatives. The S Group is a group of Finnish retail cooperatives.[25] It consists of local cooperatives and a cooperative of the local cooperatives at the top. The group is very successful and has obtained a large market share in Finland.

Finnish cooperatives are governed by the Cooperative Act (1488/2001).[26] In addition, there is a voluntary international code for cooperatives (the Rochdale Principles).

The following are the core elements of the governance model of the S-Group:

- There are local cooperatives ensuring proximity to the local retail markets
- There is a cooperative of cooperatives for economies of scale and coordination
- There are no shareholders
- Each cooperative has members, either retail customers (in the local cooperatives) or cooperatives (in the cooperative of cooperatives)
- In each cooperative, each member must by law have exactly one vote
- Membership in a local cooperative is not possible without a capital investment but members are entitled to bonuses, discounts, and other benefits
- Each cooperative has a similar governance structure with a cooperative meeting, a supervisory board, an executive board, and a CEO who is chairman of the executive board

There are similarities and differences between this model and the Ostrom model. Like in the Ostrom model, the rules are made by the participants (members). But whereas the Ostrom model leaves open how coordination should be organised, the S Group model combines the Ostrom model with a governance structure that ensures coordination. Like in the model used by German AGs, there is a clear separation of functions (a cooperative meeting, a supervisory board, an executive board); mutual

[25] *Ibid*.

[26] For the SCE, see Regulation 1435/2003, implemented in Finland through the SCE Act (906/2006).

monitoring; mixed monitoring; and a strong culture. One can now try to formulate a theory of self-enforcing corporate governance models.

8.6 How Can You Make the Model More Self-enforcing?

Several legal techniques (or institutions) can be combined to make the model more self-enforcing. They should be mutually consistent to create an environment that changes behaviour in the intended way.

First, if you cannot or will not rely on laws, you need to rely on patterns of *human behaviour* rather than laws, and on *organisational measures* (Simon 1991, Ostrom 1990). Reliance on patterns of human behaviour and on organisational measures means the use of: generic legal tools for the management of agency relationships[27]; principles of organisational risk management[28]; as well as stewardship and intra-firm competition.[29]

Second, the following practices are particularly important:

- A strong culture[30] (supported by other legal and non-legal tools and practices)
- Careful recruitment (high personal integrity of participants)
- Better transparency of the required behaviour (in particular, more bright-line rules and better documentation of the required behaviour, documented procedures for access to money)
- Better transparency of the actual behaviour since "sunlight is the best disinfectant" (increasing the number of organisation members that participate in decision management and decision control, the use of boards, joint acts, joint representation, documentation and transparency of payments)
- Mixed monitoring and mutual monitoring
- Clearer separation of functions (principle of four eyes, two-tier boards)
- Control of funding and money in safe hands (ownership of a controlling block or de facto control, money not in the hands of those who use it, money in a safe country and in a safe bank that has high integrity)
- Enforcement of sanctions for non-compliance

[27] See Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010), Chapter 6; Kraakman R, Davies P, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB, *op cit*, Chapters 1–2.

[28] Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010), section 7.4.

[29] Davis JH, Schoorman FD, Donaldson L, Toward a Stewardship Theory of Management, Acad Man Rev 22 (1997) pp 20–47; Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) pp 106–107 and 223–224.

[30] Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010), section 6.2.

Third, power is both delegated and concentrated. Power is concentrated even in models that exhibit a high level of delegation, because it is necessary in order to: manage corporate culture; manage recruitment (and the choice of "agents"); co-ordinate rule-making; coordinate training; and coordinate the enforcement of sanctions (see also Ostrom 1990). Furthermore, the long-term survival of the firm tends to require a board and the vesting of certain powers in the board (Sect. 7.8).[31]

Fourth, when the self-enforcing model requires a high level of concentration of power at the top, the following aspects become important: clear separation of functions (in particular, a two-tier board); mutual monitoring; and mixed monitoring.

Fifth, when the self-enforcing model requires the participation of multiple parties, agency costs can be reduced if the model is embedded in a favourable legal framework. The model can benefit from the existence of mandatory provisions of law.[32]

Sixth, stewardship is important. Stewardship means the use of methods that increase social incentives to act in the interests of the organisation. Social incentives can be enhanced, for example, by: collegiate decision-making supported by monitoring procedures; and competition, combined with rewarding managers that have high integrity (Simon 1991). Whereas stewardship can increase the level of self-enforcement, a high level of self-enforcement is likely to increase stewardship, and both can contribute to a stronger culture. Self-enforcement will thus create social capital that makes self-enforcement stronger.[33]

Seventh, even other factors must be taken into account when choosing the balance between delegation and concentration. The firm's ability to innovate is studied as such a factor in the next chapter.

[31] See also Mäntysaari P, The Law of Corporate Finance. Volume I. Springer, Berlin Heidelberg (2010) p 174.

[32] See even Mäntysaari P, Comparative Corporate Governance. Springer, Berlin Heidelberg (2005), Chapter 6; Mazé A, Ménard C, Private ordering, collective action, and the self-enforcing range of contracts, Eur J Law Econ 29 (2010) p 138: "supervision by public institutions may extend the self-enforcing range of contract".

[33] For social capital as civic capital, see Guiso L, Sapienza P, Zingales L, Civic Capital as the Missing Link. EUI Working Paper ECO2010/08. European University Institute, Department of Economics (2010).