

## **Strategic Reactions of Organizations to Legal Environment: A Typology for Industries in the Process of Institutionalization**

**Erdem Kirkbesoglu**

Baskent University

Turkey

### **Abstract**

*The aim of this study is to construct a typology which indicates strategic reaction of organizations against legal environment during the historical development of insurance industry which cannot complete the process of institutionalization in Turkey. In this study, institutional and resource dependence perspectives are used to the prediction of strategic reactions to institutional processes. The study offers a typology of strategic reactions that varyin active organizational defiance from passive deference to proactive manipulation. The theoretical typology constructed at the end of the study exhibits the transition from stationary legal environment to dynamic legal environment for insurance industry. In this transition period, insurance companies have tended to isomorphic inclination with this laws and related organizational applications. On the other hand, three testable propositions are reproduced for future studies from three stages of institutional process to contribute approaches and models of strategic management. The article proceeds in the following manner. First, we briefly review the literature regarding legal environment and strategic reactions of organizations to legal environment. Organization theories such as institutional theory and resource dependence theory form the basis of this study. Second, we analyze role of legal environment in the historical process of insurance industry in Turkey. We scan many historical documents, laws, regulations and politic applications. Next, we produce typology for industries in the process of institutionalization and testable propositions for future studies. Finally, we provide the research findings and discuss their organizational and theoretical implications.*

**Keywords:** influencing and compliance strategy, stable and dynamic legal environment, insurance

### **1. The Legal Environment of Organizations**

It is important that organizations harmonize themselves according to the changing environmental conditions in order to maintain their existence. As a basic result of this harmonization effort, organizations intend for a continuous interaction with their environment and by this way they try to minimize the complexity of the relationships with their environment. Therefore, the structure and characteristics of the environments where organizations exist become important. In the organization literature, the component of environment has been examined elaborately in several studies on different theoretical basis. However, studies on the relationships between organizations and their “legal environments” remain to be limited.

Legal environment of organizations include the political environment in terms of scope. State and governmental regimes, results of the elections, relationships between government – opposition party, power balances, political stability or instability, political reputability, the level of effectiveness of the relationships with the official agencies, methods of searching for rights, the tendency of various bodies of government to interfere in business life, components occurring in a political arena such as the tendency to privatization or nationalization play an important role in the development process of organizations and professional unions (Ulgen and Mirze, 2004). These components appearing in a political environment ensure functionality on organizations with the legal implementations as laws, regulations, legal decisions, judicial opinions or decisions enacted under the scope of legal environment.

The effects of legal environment on organizations may vary throughout the historical process of a country. The effects of the legal environment were generally classified in the past studies categorically. Several researches emphasized the (1) stable and (2) dynamic structures of the legal environment. We will adhere to this binary distinction in this study (Suchman, 1995).

- (1) *A stable structure of legal environment.* Organizations are restricted with laws; however, they have the freedom to act within these limits. Thus, the restrictive aspect of law is felt on organizations and creates a control effect in essence. It is not as active as to create sudden changes and enforcements on the current order of organizations. Organizations are players and the legal system is only a playground (Edelman and Suchman, 1997). In brief, in the stable structure of legal environment, organizations do not feel some legal effects. They are aware of their presence and it is a control mechanism on their actions. However, it is not in a position to urge them to change their actions.
- (2) *A dynamic structure of legal environment.* Law is quite more active. In this environment, there exist laws against discrimination, health and safety laws, antitrust law and similar kinds of laws (Edelman and Suchman, 1997). Here, law appears as a system of concrete regulations that enacts social authority on various aspects of organization life. The legal system takes initiative in order to directly change organizational behavior. While laws appear as a product of political thought, organizations aim at developing various strategies against this political force (Oliver, 1991). Hence, there is a power struggle between the state and professional unions and their administrators. The state and politicians are the most significant influencers of the stability and change in organizational field (Fligstein, 1991).

## **2. Organizational Reactions to Legal Environment**

Organizations have a two-way interaction with the legal and regulatory environment (Oliver, 1991). In this twoway interaction process, environment involves organizations' "compliance" and "influencing" struggles in line with their own interests (Usdiken, 2007). The argument of the first approach, the majority of which are composed of the institutional theorists is based on the idea that the structures of the organizations are shaped with their compliance to the organizational environment they belong to (Meyer and Rowan, 1977; DiMaggio and Powell, 1991; Scott and Meyer, 1991; Tolbert and Zucker, 1983). In contrast to this approach, there is the argument that "organizations are in an effort to manage the environment according to their interests", which is based on the resource dependence theory (Aldrich and Pfeffer, 1976).

- (1) **Influencing strategy** is the fact that organizations have the resources to affect environment or use power for the purpose of creating change against the expectations from the environment (Oliver, 1991). According to this view; law is considered as a system of concrete punishment and rewards designed to dissuade some ways of behavior or encourage some others. Organizations know well how to and when to affect the legal system in order to avoid from its harmful effects as well as abuse the benefits of law. Organizations demonstrate strategic acts against the enforcing aspect of legal environment and try to avoid from laws that can bring them economic responsibilities or manipulate legal regulations contradicting with their own interests. The theory of resource dependence suggests that environment is objectively present outside the organizations but that organizations can influence their environments depending on their observations and perceptions. Organizations have the opportunity to create something against the environment. Hence, they can respond to their environment and change it (Usdiken, 2007).
- (2) **Compliance strategy** regards organizations as mostly the cultural followers of rules and perceives law as a system of moral principles, written roles and sacred symbols. Law provides a model for organizational life, creates defining roles for organizational actors and impose positive or negative meaning on the behaviors. Law creates a system of beliefs that penetrates into the organizational life. Thus, organizations prefer adopting to this big system. The basis of this strategy is composed of the institutional theory. According to the institutional theory, the structures and processes of organizations are shaped as a result of their compliance in the institutional environment they exist in (Ozen, 2007). The institutional environment is a built environment which includes the rational structures, norms, rules, beliefs and legends formed outside and over the organizations (Ozen, 2007). According to DiMaggio and Powell, organizations adopt the structures and implementations suggested by the common laws and become isomorphic (DiMaggio and Powell, 1991). Thus, organizations prefer to accommodate in the laws and regulations established in the previous process. Organizations adopt the implementations that legal and regulatory environment previously legalized and this happens in a similar manner for all organizations. The effects leading organizations to this process are explained with the definition by DiMaggio and Powell as "institutional isomorphism" (Greening and Gray, 1994).

On the other hand, change is created in the organizational field again through the intervening and shaping effect of the legal and regulatory environment and while some professions get stronger as a result of this effect, some others weaken (Ozkara and Ozcan, 2004). Fligstein (1991), explained the reason of this political intervening effect as the power struggle between the state and the occupational groups. As a result of this, some professions prefer to accommodate to the positive discrimination by the state in terms of their own development. In conclusion of this compliance behavior based on interest, an isomorphism will appear again.

**3. Methods**

In this part of the study, the change of interaction between the legal environment and insurance firms throughout the historical process is examined. For this purpose, document analysis method was used and all laws, regulations, acts and historical documents enacted for insurance sector were investigated. As a result of this investigation, it was found out that the insurance sector has developed in three periods.

- First Period: The last periods of the Ottoman Empire (1900-1922)
- Second Period: Foundation and progress period of Turkish Republic (1923-1979)
- Third Period: Liberalization, Expansion and Adaptation Process of the European Union (1980-.....)

When the development process of insurance sector in Turkey is examined, all three periods have been a stage for various different environmental effects and organizational reactions.

**4. Findings**

In the first period, it is seen that there was a “stable” process for legal and regulatory environment while manipulative acts were experienced in terms of strategic reactions of insurance firms. It appears that there was lack of inspection during this period regarding the insurance firms. The most fundamental reason for this lack of inspection was that there was no legal sanction. Particularly, it proves the existence of a stable legal environment that insurers were led to foreign courts in case of disputes between insurers and insurance firms and that Ottoman laws were not binding. On the other hand, it can be said that insurance firms took some manipulative strategic actions in this period.

**Table 1: First Period: The last periods of the Ottoman Empire (1900-1922)**

| <b>What are important in terms of legal environment?</b>  | <b>What are the strategies of organizations?</b>   |
|---|--|
| <ul style="list-style-type: none"> <li>• Foundation of foreign insurance companies</li> <li>• Government did not create any binding effect over foreign insurance companies.</li> <li>• The languages of the first policies were French and English.</li> <li>• Moral disorder caused the unfair competition</li> <li>• Lawsuit center was general directorship of foreign insurance companies in their own country because of capitulation.</li> </ul> | <ul style="list-style-type: none"> <li>• Foreign insurance companies became a dominant actor. Because there was not any national company.</li> <li>• Insurance industry drew their way without an legal arrangement.</li> <li>• Insurance companies could cancel the policy contract whenever they want.</li> <li>• Loss indemnity was not paid with any allegation to Muslim citizens because of unrestraint conditions.</li> <li>• Capitulation was legally assurance of foreign companies.</li> </ul> |
| <b>A stable structure of legal environment</b>  | <b>Influencing strategy</b>  |

When the development of insurance sector in the second period is examined, it is seen that a “stable” process was experienced in terms of legal and regulatory environment whereas compliance behaviors were demonstrated in terms of insurance firms’ strategic reactions. Following the proclamation of the Republic, in parallel with the narrowing in all business fields, the financial situation of the insurance sector firms deteriorated as well. Moreover, the fact that Balkan lands, where insurance activities were more intense, were cross border led to the necessity for legal arrangements for insurance business remain in the background. The comfort experienced by the insurance firms due to the lack of competition in the insurance sector and accordingly not disclosing the growth target much led firms to pursue the compliance strategy.

**Table 2: Second Period: Foundation and progress period of Turkish Republic (1923-1979)**

| <b>What are important in terms of legal environment?</b>   | <b>What are the strategies of organizations?</b>   |
|--|--|
| <ul style="list-style-type: none"> <li>• Politic instability, economical problems and embargos</li> <li>• Efficient Balkan lands were lost</li> <li>• Limited legal arrangement (such as 1927 and 1959 Auditing Laws)</li> <li>• Army coup and terrorist attack</li> </ul> | <ul style="list-style-type: none"> <li>• Foreign insurance companies were followed by national companies.</li> <li>• Foreign insurance companies were dominant to diffuse information in the industry, but the diffusion of information was also limited.</li> <li>• Myth/legend companies were model for new insurance companies.</li> <li>• Easy goingness and insouciance showed an increasing among non-competitive companies.</li> <li>• New insurance companies had tried to harmonize in their environment</li> </ul> |
| <b>A stable structure of legal environment</b>   | <b>Compliance strategy</b>   |

Yet, the third period, liberalization and foreign expansion process, is a time considered “dynamic” in terms of legal and regulatory environment and a process where firms have demonstrated “accommodating” behaviors in terms of the strategic reactions of insurance firms. It is seen that liberalization movements are on the agenda of the sector and several laws are enacted for the purpose of EU harmonization process.

**Table 3: Third Period: Liberalization, Expansion and Adaptation Process of the European Union (1980-...)**

| <b>What are important in terms of legal environment?</b>  | <b>What are the strategies of organizations?</b>  |
|---|---|
| <ul style="list-style-type: none"> <li>• Liberalization of insurance industry after 1980</li> <li>• Free tariff system</li> <li>• Branching of life and non-life insurances (as a new form of organization)</li> <li>• Government support founding of new insurance companies</li> <li>• Legal gaps were limited with the help of legal enactments.</li> <li>• Founding of Turkish Undersecretariat of Treasury.</li> <li>• Founding of Turkish Catastrophe Insurance Pool in 2000.</li> <li>• Founding of Pension System in 2001.</li> <li>• Legalization of agricultural insurance law and Founding of Agricultural Insurance Pool in 2005</li> <li>• Legalization of New Insurance Law in 2007</li> <li>• Founding of Assurance Account, and Insurance Education Center.</li> <li>• Insurance expert system, insurance agency and insurance arbitration systems were renewed.</li> </ul> | <ul style="list-style-type: none"> <li>• High adoption of all insurance companies</li> <li>• Buying and joining have showed an increasing with new foreign companies</li> <li>• New insurance companies have tried to harmonize to Turkish insurance industry.</li> </ul> |
| <b>A stable structure of legal environment</b>  | <b>Compliance strategy</b>  |

## 5. Conclusion

As a result, one of the most significant factors causing this change is the regulatory structures. State sourced policy and rules are the most essential sources of the stability and change in the field (Fligstein, 1991). The state can ensure a continuity and stability by defining the rules of the game at a certain area (a stable legal environment) while it can change the actions of organizations by altering the rules (a dynamic legal environment) (Fligstein, 1991). The possible cooperation that may arise in the field can be in direct proportion with the interests of actors such as politicians or the owners of important insurance firms. Thus, while the state’s active role is in the foreground in the historical process of some professional groups, which causes a continuous change in the field, it has remained limited with the regulatory scope with laws and rules for some professions and determined the boundaries. At this point, the insurance sector has been the one that the state has increased its effect particularly after 1990s in Turkey.

|                     |             | Legal Environment  |   |
|---------------------|-------------|--|---|
|                     |             | Stable   | Dynamic   |
| Strategic Reactions | Compliance  | Foundation and progress period of Turkish Republic<br>I<br>↑ | Liberalization, Expansion and Adaptation Process of the European Union<br>II<br>↓ |
|                     | Influencing | The last periods of the Ottoman Empire<br>III                | IV  |

**Figure 1. Typology: Strategic Reaction of Organizations against Legal Environment**

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