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**Winning Legally:
The Value of Legal
Astuteness**

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“Winning Legally: The Value of Legal Astuteness”

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Abstract

This paper explores the value of actively managing the legal dimensions of business. It draws on the dynamic capabilities approach and postulates that “legal astuteness” – defined here as the ability of the top management team to communicate effectively with counsel and to work together to solve complex problems – is a valuable dynamic capability. This paper posits that law and the tools it offers are an enabling force legally astute management teams can use to manage the firm more effectively. In particular, it proposes that legally astute management teams can, *inter alia*, use formal contracts as complements to relational governance to define and strengthen relationships and reduce transaction costs; create options; protect and enhance the realizable value of knowledge assets and certain other resources; and convert regulatory constraints into opportunities.

In the last thirty years, law has become an increasingly salient feature of the business environment (Nelson & Nielsen, 2000). Yet, there has been a persistent neglect of governments as contexts in organizational behavior research (Ring, Bigley, D'Aunno, & Khanna, 2005), and “much organizational research remains relatively naïve about the organizational implications of the law” (Barney, Edwards, & Ringleb, 1992). This paper seeks to address this gap in the literature concerning the role of law at the firm level by exploring the value of actively managing the legal dimensions of business.

To date, management scholars have tended to focus on the regulatory and legitimizing aspects of law (DiMaggio & Powell, 1983; Scott, 1987; Suchman, 1995). A substantial body of literature addresses the political (Hillman & Hitt, 1999) and other “nonmarket strategies” (Baron, 1995) firms pursue to help shape the external regulatory environment within which they do business (see, for example, Yoffie & Bergenstein, 1985; Keim & Zeithaml, 1986; Yoffie, 1987; Hillman & Hitt, 1999; Aggarwal, 2001; Shell, 2004; Bonardi, Hillman, & Keim, 2005). Legal institutions do more than regulate and constrain (Edelman & Suchman, 1997; Samuels, 1989), however. Laws liberate individual action (Commons, 1970) and facilitate various interorganizational interactions (Pearce, 2001). The law offers a toolkit that organizations can employ as part of their market strategy to construct various legal devices, such as employment contracts, proprietary information agreements, stock options, and technology licenses (Suchman, Steward, & Westfall, 2001).

This paper draws on the dynamic capabilities approach (Teece, Pisano, & Shuen, 1997) and postulates that “legal astuteness” – which I define as the ability of a top management team (TMT) to communicate effectively with counsel and to work together to solve complex problems – is a valuable dynamic capability. The dynamic capabilities approach asserts that the winners in today’s “Schumpeterian world of innovation-based competition, price/performance rivalry, increasing returns, and the ‘creative destruction’ of existing competencies” (Teece, Pisano, & Shuen, 1997: 509) have been the firms that “can demonstrate timely responsiveness and rapid and flexible product innovation, coupled with the management capability to effectively coordinate and redeploy internal and external competencies” (1997: 515). This paper offers theoretical support for the assertion in Bagley (2000) that managers can use law to create and capture value, and it suggests that legal astuteness may, in certain contexts, be a source of sustainable competitive advantage under the resource-based view of the firm (Barney, 1991).

The paper begins by outlining the four components of legal astuteness: (1) a set of attitudes, (2) a proactive approach, (3) the ability to exercise informed judgment, and (4) context-specific knowledge of the law and the appropriate use of legal tools. It then posits that legal astuteness can increase realizable value in

at least four ways. First, it proposes that legally astute management teams can use formal contracting and relational governance as complements to define and strengthen relationships and to reduce transaction costs. Second, it explains how legally astute management teams can use contracts and other legal tools to create options. Third, it discusses the ability of legally astute management teams to protect and enhance the realizable value of knowledge assets and certain other resources. Fourth, it explains how legally astute management teams who go beyond compliance with the letter of the law can convert regulatory constraints into opportunities for value creation and capture. Conversely, the paper points out that failure to integrate law into the development of strategy and of action plans can place a firm at a competitive disadvantage and imperil its economic viability. Certain organizational issues, including the risk that inside counsel actively involved in strategy formulation and execution will lose their objectivity, are then addressed. The paper then asserts that the value of legal astuteness and its effect on firm performance is moderated by the firm's strategy formulation and external environment. The paper concludes by calling for future theoretical work and empirical research to determine whether and under what circumstances legal astuteness can be a source of sustained competitive advantage under the resource-based view of the firm (Barney, 1991).

In this paper I focus on the U.S. legal regime and use the term "law" to include the U.S. and state constitutions, statutes enacted by the Congress and state legislatures, regulations promulgated by federal and state regulatory agencies and their associated enforcement policies, and common law established by the courts in the course of deciding specific cases. This includes the law of contracts whereby private parties can enter into binding agreements that will be enforced by the power of the state.

Many of the arguments in this paper would apply to managers in firms based outside of the United States. First, a number of the legal tools addressed in the paper, such as contracts and intellectual property protection, are available (albeit to varying degrees) throughout the world. Second, many managers based outside of the United States will work for companies that either (1) have operations in the United States or (2) import products from, or export products to, the United States. Because the United States applies its laws extraterritorially to conduct occurring outside of the United States that has substantial effects in the United States, even managers based outside of the United States can find themselves sued or prosecuted under U.S. law. Finally, U.S. law has influenced other countries in areas such as environmental, product liability, and insider trading laws. Nonetheless, when trying to explain managerial behavior, one must be very careful when trying to generalize across cultures (Geletkanycz, 1997). Especially when faced with ambiguity and complexity, managers filter information and interpret stimuli using lenses shaped by their knowledge, beliefs, assumptions (March & Simon, 1958; Cyert & March, 1963), and values

(Hambrick & Mason, 1984). Because societal values vary across cultures (Hofstede, 1991), the value a particular culture puts on complying with the law or honoring promises, for example, and the local norms regarding the use of lawyers could dramatically affect a top management team's approach to legal compliance and the use of lawyers and various legal tools.

ATTAINING LEGAL ASTUTENESS

The managerial capability of legal astuteness has four components: (1) a set of attitudes, (2) a proactive approach, (3) the ability to exercise informed judgment, and (4) context-specific knowledge of the relevant law and the appropriate application of legal tools.

The Attitudinal Component

Legally astute management teams recognize the importance of law to firm success. They accept responsibility for managing the legal aspects of business and do not delegate those decisions to persons, such as counsel, who may not understand the broader business objectives. They recognize that it is the job of the general manager, not the lawyer, to decide which allocation of resources and rewards makes the most business sense. At the end of the day, as long as counsel has not advised that a particular course of action is illegal, it is up to the management team to decide whether a particular risk is worth taking or a particular opportunity is worth pursuing.

At the same time, legally astute managers—even those with formal legal training—do not purport to advise themselves on legal matters of importance. They appreciate the importance of selecting a true counselor at law who combines knowledge of the black-letter law with judgment and wisdom. As Yale Law School Dean Anthony T. Kronman (1995) explained, wisdom is more than technical skill: It is the capacity to offer deliberative advice, that is, to go beyond merely supplying whatever means are needed to achieve the client's goals and to deliberate with the client about the wisdom of the client's ends (Kronman, 1995: 132-133). It requires character, as well as information and intelligence, to resolve the moral dilemma resulting from the divided allegiances inherent in our legal system: Lawyers are expected to be "partisan champions of their clients' interest" but also to be "impartial officers of the court, duty-bound to uphold the law's integrity" (1995: 144). Resisting the temptation to resolve the dilemma by always putting the client's well-being before the law's requires courage and civic-mindedness (1995: 145). According to Ben Heineman, General Electric's senior vice-president, law and public affairs, "Nowadays every firm should have its own in-house lawyer-statesman" who supplies practical wisdom and not just technical mastery, understands long-term effects, and evinces a deep concern for the public interest as well as for the private good of the firm. (*Economist*, 2004). Or as Elihu Root put it: "About half the practice of a decent lawyer consists in

telling would-be clients that they are damned fools and should stop” (Linowitz & Mayer, 1994: 4).

Legally astute TMTs also understand that law is rarely applied in a vacuum and that its application to a given set of facts is often not clear-cut. Legal inference is often highly ambiguous (Langevoort & Rasmussen, 1997). Although Congress and the U.S. Supreme Court have declared certain conduct, such as horizontal price-fixing between direct competitors, to be clearly illegal, the legal analysis of most courses of action is far more subtle. There are large gray areas.

Legally astute management teams acknowledge that “moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied” (American Bar Association, 2002: 70). Moreover, law and the ways it is interpreted change over time. As U.S. Supreme Court Justice Oliver Wendell Holmes (1897) explained, legal advice is often just a prediction of what a judge and jury will do in a future case. Accordingly, legally astute management teams understand the importance of anticipating tomorrow’s laws and of trying to predict how existing laws may be interpreted and enforced in the future.

The Proactive Component

Rather than viewing the law purely as a constraint, something to react to and comply with, legally astute management teams take an active role in managing the legal dimensions of business. They include legal constraints and opportunities at each stage of strategy formulation and execution. Because decisions made in the early stages can dramatically affect the courses of action available in the later stages, they recognize inside counsel’s “right and responsibility to insist upon early legal involvement in major transactions” (Chayes & Chayes, 1985: 281) and bring counsel in early in the cycle of decision-making. They do not treat their lawyers as a “necessary evil” (Nelson & Nielsen, 2000: 474) or wait until the last minute to fight a fire that has already started or to bless a deal that has already been struck.

Instead of seeking merely technical legal advice, legally astute management teams call on their lawyers to refer to moral, economic, social, and political factors when giving advice. Legally astute teams work with counsel to comply with the law and take a proactive approach to regulation, both to avoid more onerous government regulation and to take advantage of the innovation opportunities regulation and deregulation offer. They demand legal advice that is business oriented, and they expect their lawyers to help them address business opportunities and threats in ways that are legally permissible, effective, and efficient. They avoid lawyers who respond to questionable proposals by saying, “[Y]ou cannot do that because it is illegal, period,” and they seek out attorneys

who are more likely to respond, "Maybe," then ask, "Have you looked at a different approach?" (Daly, 1997: 1062-1063).

Legally astute management teams expect their lawyers to function as "counsel" and "entrepreneurs" not as "cops" (Nelson & Nielsen, 2000). *Cops* are gatekeepers who are primarily concerned with policing the conduct of the business units. They are very reluctant to offer non-legal advice. *Counsel* play a significant gatekeeper role as well but also provide a mix of legal, business, and situational advice. *Entrepreneurs* offer non-legal advice on business decisions, participate in strategic planning, and market the legal function as a source of profits. Nelson and Nielsen found that 17% acted as cop, 33% as entrepreneur, and 50% as counsel. Research concerning the role of inside counsel in the 1960s and 1970s revealed cops and counsel but not entrepreneurial lawyers (Nelson & Nielsen, 2000).

Legally astute teams help their lawyers learn about the business and provide ongoing business information so their lawyers can participate actively in each stage of strategy formulation and execution. In the same way that the business-related capabilities of human resource professionals appear to be important contributors to strategic human resource management activities (Huselid, Jackson, & Schuler, 1997), one would expect the business-related capabilities of the firm's lawyers to be positively associated with the effective management of the legal dimensions of business.

The legally astute approach to the management of the legal dimensions of business is depicted in Figure 1.

Figure 1: The Legally Astute Approach



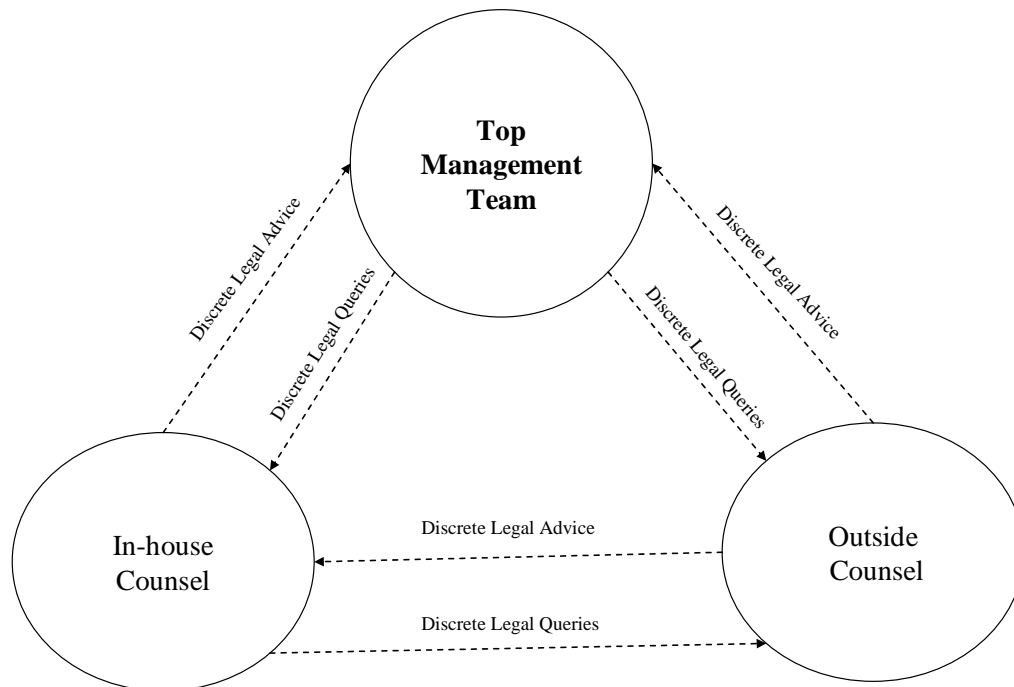
This model shows a direct line of communication between the top management team and outside counsel. The general counsel often selects outside counsel and sometimes denies the outside lawyers direct access to top management (Rosen, 1989, 2002). This practice may reduce the costs to a corporate client of switching counsel (Gilson, 1990) by reducing informational asymmetries between lawyers and their corporate clients (Gilson & Mnookin, 1985), but it poses several problems. First, this practice may cause the outside counsel to view the general counsel not the business managers as the client. Second, because of the close relationship the general counsel often has with the CEO (Kim, 2001), the general counsel may be less willing than outside counsel to confront or challenge the CEO. Third, information can be distorted when communicated through an intermediary. Providing direct access avoids these problems.

In the absence of legal astuteness, the counsel-manager communication often takes the form of reaction-counteraction. Despite their limited legal expertise, managers are often reluctant to ask their attorneys too broad a question for fear that they might receive an answer that would preclude them from doing what they really want to do. So, the client instead frames a very

technical question to the attorney, to which the attorney frames an equally technical answer, again without regard to why the question is being asked or the broader business context within which it is being raised (Linowitz & Mayer, 1994).

Management teams lacking the requisite degree of legal astuteness tend to view legal considerations as an afterthought or add-on to the firm's business strategy. They often view the firm's lawyers as technical consultants to be brought in on an episodic basis when the firm is confronted with a discrete legal problem or after the management team has already decided what to do (Linowitz & Mayer, 1994). They formulate strategy and decide how best to implement it, then begrudgingly run the business decision by the legal team to determine whether it poses an unacceptable legal risk. This approach is depicted in Figure 2.

Figure 2: The Non-Legally Astute Approach



Consider the board of directors of Enron, who asked Enron's long-time outside counsel Vinson & Elkins whether the board needed to take any action in response to an employee memo claiming accounting irregularities. The board expressly told Vinson & Elkins not to "second guess" Andersen's accounting

treatment (Oppel & Eichenwald, 2002). Vinson & Elkins duly responded to this very narrow inquiry with a reply that acknowledged that the accounting treatment was “creative and aggressive” and that there was a “serious risk of adverse publicity and litigation” due to the “bad cosmetics” of certain transactions, but concluded that no further investigation was needed (Oppel & Eichenwald, 2002). The special committee of the board appointed to investigate the accounting debacle at Enron faulted Vinson & Elkins for its failure to look at the whole picture and to advise the board to probe deeper into the alleged accounting irregularities.

There are degrees of legal astuteness. Table 1 summarizes the key characteristics associated with low and high degrees of legal astuteness.

Table 1: Degrees of Legal Astuteness

		DEGREE OF LEGAL ASTUTENESS		
		Low	High	
CHARACTERISTICS	<i>Attitude of TMT Toward Legal Dimensions of Business</i>	Not My Responsibility	Important Part of My Job	
	<i>TMT View of Lawyers</i>	Necessary Evil	Partner in Value Creation and Risk Management	
	<i>Role of General Counsel (GC)</i>	Cop	Counsel	Entrepreneur
	<i>Frequency of GC Contact w/CEO</i>	Low		High
	<i>Flow of Business Information and Legal Queries</i>	On a Discrete Issue-by-Issue Basis		Ongoing
	<i>GC Is Member of TMT</i>	No		Yes
	<i>TMT Approach to Legal Issues</i>	Reactive		Proactive
	<i>Involvement of TMT in Managing Legal Aspects of Business</i>	Hands Off		Hands On
	<i>TMT Approach to Regulation</i>	Do Minimum to Comply		Exceed Regulatory Requirements as Result of Operational Changes that Increase Realizable Value
	<i>Involvement of Lawyers in Strategy Formation</i>	Low		High
	<i>Involvement of Managers in Resolving Business Disputes</i>	Low		High
	<i>Involvement of Managers in Contract Negotiation</i>	Low		High
	<i>Involvement of Lawyers in Striking Deal</i>	Low		High
	<i>Legal Literacy of Managers</i>	Low		High
	<i>Business Acumen of Lawyers</i>	Low		High

The Judgment Component

Law is not an exact science. Legal rules are not applied formulaically. Seemingly minor changes in facts can result in dramatically different legal outcomes. Often, there is no clear precedent to serve as a guide. Dealing with the uncertainties inherent in many decisions with legal aspects (Langevoort & Rasmussen, 1997) requires the exercise of informed judgment. Legally astute management teams understand the legal ramifications of their actions and are able to factor legal uncertainties into business decisions in the same way that other uncertainties, such as currency fluctuations or a shortage of raw materials, are factored into the risk/reward calculation.

Part of the top management team's job is integrating all manner of perspectives, from financial experts, HR professionals, and marketing managers to lawyers. General managers must decide how much to spend to obtain more information, whether it is market research or a legal opinion. Even when a company can afford to hire the best and brightest lawyers, the fact is that even the smartest lawyers get it wrong sometimes.

In certain instances, lawyers may have economic reasons to overstate legal risk. By identifying risks that can be managed only with careful legal guidance, the lawyer is able to justify spending more time on both legal research and transactional assistance, such as contract drafting and negotiation, and thereby maximize his or her income (Langevoort & Rasmussen, 1997). In addition, a lawyer is more likely to incur a reputational (and perhaps financial) penalty if the lawyer advises a client to proceed with a transaction that is later deemed unlawful than if the lawyer either advises against proceeding or advises proceeding only with excessive and costly precaution (Langevoort & Rasmussen, 1997). Professional norms may also prompt lawyers to err on the side of caution, as may the cognitive biases that come into play when lawyers are faced with high ambiguity (Langevoort & Rasmussen, 1997).

Sometimes, the need to keep an important client happy or overconfidence bias can cloud lawyers' judgment. Lawyers often overestimate their ability to resist the social and cognitive pressures that can compromise their judgment (Langevoort & Rasmussen, 1997). For example, litigators are often overly optimistic about their chances of winning even when the statistics on similar cases would suggest a lower probability of success (Kahneman & Lovallo, 1993). Managers need to take such biases into account when factoring legal advice into business decisions.

Consider the lawyers representing Texaco in the 1984 case brought by Pennzoil for tortious interference with its contract to acquire Getty Oil. They were so sure that Pennzoil's claims had no merit that they persuaded Texaco's board of directors that Texaco should not even dignify the claims by putting on a

damages expert (Bagley, 2005). Provided with only the assertion by Pennzoil's experts that Pennzoil lost \$7.5 billion when Texaco acquired Getty instead, the jury awarded Pennzoil \$7.5 billion in compensatory damages. Had Texaco's expert testified, he would have explained that at most Pennzoil lost \$500 million, the difference between the price Texaco paid for Getty in an arm's length transaction and the price Pennzoil had agreed to pay. James W. Kinnear, who was vice-chair of Texaco during its fight with Pennzoil, came away from the experience convinced that no CEO should ever put the firm's very survival at risk by resting its fate in the hands of a jury even when the lawyers insist that the other side has no chance of winning (Bagley, 2005). In contrast to Texaco's litigation tactics, consider the approach Charles Prince III, former general counsel of Travelers Insurance and current CEO of Citigroup, took to resolving claims of securities fraud arising out of Citigroup's work for WorldCom. He declared victory when he was able to settle the claims for \$2.53 billion and thereby avoid what he dubbed a "\$50 billion roll of the dice" (O'Brien, 2004).

Legally astute TMTs exercise the sort of judgment Prince exemplified and are not overly deferential to their lawyers. They understand that every legal dispute is a business problem requiring a business solution (Bagley, 2000). Often, litigation results in a zero-sum game, with a clear winner and loser. There are fewer opportunities for integrative bargaining (Raiffa, 1982) once a dispute goes to litigation. Legally astute teams take responsibility for managing their disputes and do not hand them off to their lawyers with a "you-take-care-of-it" approach and should, therefore, achieve better outcomes.

The Knowledge Component

Although the experienced manager may understand the role that law plays in setting the rules of the game, it is often less obvious how law affects the risk/reward ratio for any given venture. To become legally astute, managers must attain a degree of legal literacy appropriate to their context and learn the proper application of legal tools.

Hinthorne (1996: 251) presented three examples from the airlines industry to support his assertion that "lawyers and corporate leaders who *understand the law and the structures of power in the U.S.A.* have a unique capacity to protect and enhance share-owners wealth" (emphasis in original): (1) American Airlines' successful defense against predatory pricing claims by Continental Airlines and Northwest Airlines in 1993; (2) Continental Airlines CEO Frank Lorenzo's decision in 1983 to file bankruptcy to annul its union contracts and force its workers to accept a substantial cut in wages and benefits; and (3) the ultimately unsuccessful attempt in 1992 by officials of American Airlines, Delta Air Lines, and United Airlines to persuade Transportation Secretary Andrew Card Jr. to withdraw flying certification rights from airlines that had filed for Chapter 11 bankruptcy (namely, Continental Airlines, Trans World Airlines, American West

Airlines, and Metro Airlines). Siedel (2002) and Shell (2004) provided additional examples. One would expect legal knowledge to be particularly important in highly regulated or recently deregulated industries, such as air transportation, energy, banking, and insurance.

Legal Literacy. To achieve legal astuteness, managers must be able to understand what their lawyers are talking about. Managers and lawyers employ distinct mental models, which impedes their ability to take advantage of each other's area of professional expertise. They speak distinct professional dialects, further enhancing the potential for misunderstanding. As Daft and Lengel (1986: 564) succinctly put it: "[A] person trained as a scientist may have a difficult time understanding the point of view of a lawyer." The same is true of a person trained as a manager.

Consider Arthur Andersen's conviction for obstruction of justice after shredding boxes of documents relating to its audit of Enron Corporation (Oppel & Eichenwald, 2002). The shredding began right after one of Arthur Andersen's attorneys, Nancy Temple, sent an e-mail to the Andersen employees working on the Enron audit admonishing them to comply with Andersen's document retention policy. At trial, the Andersen partner in charge of the Enron account testified that he interpreted the e-mail as a call to start shredding documents. Temple claimed that her e-mail was misconstrued.

The expression "document retention policy" is a euphemism lawyers use to describe what is meant to be a fairly methodical process by which companies destroy classes of documents, including documents that could later prove difficult to explain (Schweich, 1998: 54-58). By merely parroting back to the Houston employees the fact that Andersen had such a policy, Temple failed to alert the Houston employees to the fact that it is illegal to destroy documents in the face of an existing or imminent governmental investigation or lawsuit.

To work together effectively, lawyers and managers must be able to understand what the other is concerned about. Managers and their lawyers need a common vocabulary to "typify and stabilize experiences and integrate those experiences into a meaningful whole" (Pettigrew, 1979: 575). As Mills (1972: 62) explained: "A vocabulary is not merely a string of words; immanent within it are societal textures—institutional and political coordinates. Back of a vocabulary lie sets of collective action."

Managers who understand terms such as "fiduciary," "*respondeat superior*," and "contract" have a new way of talking about people and their relationships, a new "way of organizing future experience" (White, 1973: 215-216). Because "language determines what we see" (Thompson, 1978: 5), managers who can harness the creative power of legal language are more adept

at seeing the legal structure of their world. They are also better equipped to communicate with their lawyers.

Legal Tools. The law offers a variety of tools legally astute management teams can use to increase realizable value and to manage risks. The legal tools of greatest relevance to managers will vary with the firm's overall strategy, its external environment, and with the stage of development of the business. Certain tools, such as contracts, have broad application.

Table 2 maps various legal tools onto the managerial objectives of creating and capturing value and managing risk during five stages of business development: (1) evaluating the opportunity and defining the value proposition, which includes developing the business concept for exploiting the opportunity; (2) assembling the team; (3) raising capital; (4) developing, producing and marketing the product or service; and (5) harvesting, usually through sale of the venture, an initial public offering of stock, or reinvestment and renewal.¹ Table 2 does not purport to be an all-inclusive list of techniques for using the law to increase realizable value while managing risk. Rather, it is intended to suggest both the variety and the pervasive nature of the tools available.

¹ These stages are derived from those set forth in Stevenson, Roberts, & Grousbeck (1985: 17-21).

Table 2: Legal Tools for Increasing Realizable Value While Managing Risk

Stages of Business Development

		Evaluating Opportunity and Defining Value Proposition	Assembling Team	Raising Capital	Development, Production, Marketing and Sale of Product or Service	Harvest
Managerial Objectives	Create and Capture Value	<p>Determination of whether idea is patentable or otherwise protectable.</p> <p>Examination of branding possibilities, including selection and registration of trademarks.</p>	<p>Selection of appropriate form of business entity.</p> <p>Structuring appropriate equity incentives for employees.</p> <p>Entering into nondisclosure agreements and assignments of inventions.</p> <p>Securing intellectual property protection.</p>	<p>Negotiation of downside and sideways protection and upside rights for preferred stock.</p> <p>Imposition of vesting requirement for at least some founder stock.</p> <p>Determination of whether it is possible to sell stock in an exempt transaction or registration is required.</p>	<p>Implementation of trade-secret policy.</p> <p>Consideration of patent protection for new business processes and other inventions.</p> <p>Selection of a strong trademark and plan to protect it.</p> <p>Registration of copyrights.</p> <p>Entering into licensing agreements.</p> <p>Creation of options to buy and sell.</p> <p>Securing distribution rights.</p> <p>Consideration of whether to buy or build, then negotiation of appropriate contracts.</p>	<p>Determination of whether employee vesting accelerates on an initial public offering or sale.</p> <p>Assessment of ability and desirability of exercising investor demand registration rights or board control to force initial public offering or sale of company</p> <p>Consideration of exemptions for sale of restricted stock.</p> <p>Negotiation and documentation of arrangements with underwriter or investment banker.</p>

Manage Risk	Determination of whether anyone else has rights to opportunity.	Documentation of founder arrangements. Analysis of any covenants not to compete or trade secret issues. Arbitration or mediation of disputes. Compliance with anti-discrimination laws in hiring and firing. Implementation of harassment policy. Documentation of employee performance issues. Education of employees concerning discoverability of e-mail. Establishment of appropriate mechanisms to protect whistle-blowers.	Inclusion of representations and warranties in stock purchase agreement with or without knowledge qualifiers. Choice of business entity with limited liability. Techniques to ensure respect of corporate form to avoid piercing of corporate veil.	Negotiation of purchase and sale contracts. Limitations on liability and releases. Securing insurance for product liabilities. Recalling unsafe products. Ensuring safe workplace. Implementation of compliance system. Due diligence before buying or leasing property to avoid environmental problems. Integration of products to avoid illegal tying. Ban on horizontal price fixing. Finding business solutions to legal disputes. Avoiding misleading advertising. Tax planning, filing of tax returns on time, and payment of taxes when due.	Consideration of difference between letter of intent and contract of sale. Negotiation by buyer of no-shop agreement to preclude seller from soliciting other bidders. Negotiation by seller of fiduciary out to preserve right to accept a better offer in exchange for a break-up fee. Full disclosure in prospectus or acquisition agreement. Securing indemnity rights. Due diligence procedures. Allocation of risk of unknown or uncertain through contract. Taking appropriate steps to ensure board of directors is informed and disinterested and entitled to protection of business judgment rule. Enactment of policies banning insider trading and policing trades by insiders.
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Source: Adapted from Bagley (2005: 16-17).

LEGAL ASTUTENESS IS A VALUABLE CAPABILITY

Legally astute management teams have the ability to identify and pursue 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 in at least four ways. First, they can use formal contracts as complements to relational governance to define and strengthen relationships and reduce transaction costs. Second, they can use contracts and other legal tools to create options. Third, they can protect and enhance the realizable value of knowledge assets and certain other resources. Fourth, they can convert regulatory constraints into opportunities.

Defining and Strengthening Business Relationships and Reducing Transaction Costs

Relationships are fundamental to every business—without them, it is impossible to engage in commercial activities (Baker, 1990; Bourdieu, 1986; Nahapiet & Ghoshal, 1998). Indeed, one of the primary functions of management is to initiate, develop, organize, and maintain relationships that provide an enterprise with valuable resources, market access, and growth opportunities (Baker, 1990).

Contract law (a *sine qua non* for modern economies, according to North and Weingast (1989)) makes it possible for market players to agree on their own private rules. Under the dynamic capabilities approach, a firm's position includes its enforceable rights and contracts with suppliers and complementors (Teece, Pisano, & Shuen, 1997). Courts will enforce this “manager-made law” as long as it does not conflict with fundamental public policies embodied in the public rules (Bagley, 2002). For example, the antitrust laws make certain contracts, such as horizontal price-fixing agreements, illegal and unenforceable. There is a risk that the signaling Porter (1996) proposes firms utilize to voice displeasure with competitors can lead to price-fixing, market diversion, or other illegal collusive arrangements (Fried & Oviatt, 1989). Courts will also not enforce unconscionable agreements, those that allocate risk in an unreasonable manner or that result in oppression or surprise. Part of legal literacy is understanding the public policy limits on private ordering.

Parties may go to court to enforce their contractual rights, set up private dispute resolution mechanisms, or bargain informally to resolve failures of performance. Because the alternative to private dispute resolution is often the courts, bargaining typically takes place “in the shadow of the law” (Cooter, Marks, & Mnookin, 1982; Macneil, 1980: 94).

The transaction cost economics (TCE) literature (e.g., Williamson, 1985, 1996) is the main exception to the tendency of management scholars to see law as an external force constraining managers. Firms use contracts to protect against

exchange hazards, such as opportunism and renegeing, which are often associated with uncertainty, specialized asset investments, and difficult performance measurement (Williamson, 1985, 1996). For example, long-term contracts can buffer a seller from the instability that can result from dependence on a single critical buyer (Pfeffer & Salancik, 2003). Gilson (1984) argued that business lawyers create value by acting as “transaction cost engineers.” He cited the use of an earnout arrangement in the sale of a business as a valuable technique for addressing information asymmetry, risk, and uncertainty.

Yet, not all firms are equally adept at achieving the expected gains from their formal contracts (Lacity & Willcocks, 1998; Poppo & Zenger, 2002). This systemic variation among firms suggests the existence of a distinct firm-specific capability or competence. Barney and Hansen (1994) posit that managers who are highly skilled in managing contractual forms of governance, such as complete contingent claims contracts that specify the economic costs that will be imposed on parties engaging in opportunistic behavior, will have a competitive advantage over those who must use more costly market forces of governance (such as equity joint ventures) or hierarchical forms of governance to protect against exchange vulnerabilities. This paper builds on that argument and asserts that the interfirm variance is explained by the construct of legal astuteness.

Some scholars argue that social norms, such as trust and agreed-upon processes embedded in social relationships, operate as self-enforcing safeguards that are more effective and less costly than either explicit contracts or vertical integration (Hill, 1990; Dyer, 1997; Uzzi, 1997; Dyer & Singh, 1998). They assert that formal contracts may actually undermine a firm’s ability to develop relational governance by signaling distrust of the other party (Macaulay, 1963; Ghoshal & Moran, 1996).

Poppo and Zenger used data on outsourcing relationships in information services during the early 1990s as evidence for their alternate argument that well-specified contracts may actually promote more competitive long-term, trusting exchange relationships (Poppo & Zenger, 2002). Contrary to the assertion that formal contracts undermine relational governance, they argued that “clearly articulated contractual terms, remedies and processes of dispute resolution as well as relational forms of flexibility, solidarity, bilateralism, and continuance may inspire confidence to cooperate in interorganizational exchanges” (Poppo & Zenger, 2002: 712).

Their research revealed that relational governance and contract customization both directly and indirectly increased exchange performance as measured by satisfaction with the cost, quality, cost, and responsiveness of the outsourced service (Poppo & Zenger, 2002). This is consistent with one lawyer’s statement that he was “sick of being told, ‘we can trust old Max’ when the problem is not one of honesty but one of reaching an agreement that both sides

understand” (quoted in Macaulay, 1963: 58-59). This approach is also consistent with Klein and Leffler (1981) and the assertion by North and Weingast (1989) that repeat play and reputation alone are insufficient to police reneging, making more complex institutional arrangements necessary. Poppo and Zenger further found that increases in the level of relational governance were associated with greater levels of contractual complexity and that increases in the level of contractual complexity were associated with greater levels of relational governance.

Parties are more likely to achieve the complementarity between relational governance and contract customization that Poppo and Zenger (2002) found if the process of contracting does not create mistrust, generate ill will, or otherwise undermine the social norms against opportunistic behavior and reneging. The process of negotiating a formal contract can be an adversarial, zero-sum process that encourages each side to include, and often memorialize in obscure language, complex terms to extract rents from the other party (Bifani, 2003). Outside counsel in particular may go from deal to deal without focusing on the effect their negotiating style might have on the relationship going forward (Ertel, 2004). Legally astute management teams should be better able to help their lawyers follow the recommendation of Bifani (2003: 25) that attorneys replace the “zero-sum game of adding language that is felt to be in their client’s interest and deleting contrary language” with “a careful analysis of the client’s business objectives [to determine] precisely what rights are necessary to protect these objectives....”

The point here is simple: the ability of a firm to realize value from its formal contracts will, at least in certain contexts, depend not only on the wording of its contracts but also on the process by which they were negotiated. Managers who participate actively in contract negotiations should be better able both to ensure that their lawyers understand the business implications of various negotiating positions and to temper, as appropriate, the lawyer’s zeal to “win points” from the other side. At the same time, managers who involve their lawyers in the process of crafting the deal structure and terms at the outset should achieve more favorable results than those who first reach an agreement in principle with their counterparts on the key business terms then leave it up to the lawyers to “paper the deal.” If this reasoning is correct, then we should find that legally astute management teams realize more value from their contractual relationships than teams lacking legal astuteness. More specifically, just as Lacity & Willcocks (1998: 37) found that senior executives and information technology (IT) managers who made sourcing decisions together achieved expected cost savings with a higher relative frequency than either group acting alone, I would expect that managers and lawyers who make contractual decisions together would achieve the expected exchange performance with a higher relative

frequency than teams that have their managers first strike the business deal then bring in the lawyers to document it.

Legally astute management teams should also be more attuned to any indications that the relationship is faltering and be more successful resolving disputes. The solution may involve litigation, but legally astute management teams remain actively involved in both the key litigation decisions and the settlement talks to ensure that the firm's litigation strategy is consistent with its business strategy.

Creating and Preserving Options

Contracts and certain other legal tools can be used to create and preserve options. An option, which is sometimes but not always embodied in a contract, is an investment in the right but not the obligation to defer a decision until additional information becomes available or uncertainties are otherwise resolved. Real options theory posits that there is value inherent in the right to delay a decision that is characterized by uncertainty (Kogut & Kulatilaka, 2001).

For example, an option to buy stock can be a valuable option to defer. A firm might merge with another or enter into a joint venture to stabilize exchange relationships, especially when operating in a highly interconnected environment (Pfeffer & Salancik, 2003). A clear contractual right to terminate a joint venture can be a valuable option to abandon. Subjecting a founder's shares to vesting and hiring employees at-will enhance a venture capitalist's ability to change the management team in the future. Coinvestment rights preserved their option to invest in later financing rounds. Investors who understand how to use such tools effectively should achieve higher performance than those lacking that capability.

Certain options, such as the option to buy or lease real property, require written contracts to be enforceable. Others can be agreed to orally but often firms put them in writing to avoid later disputes about what was agreed to. As U.S. Court of Appeals Judge Frank Easterbrook explained: "Memory plays tricks. Acting in the best of faith, people may 'remember' things that never occurred but now serve their interests. Or they may remember events with a change of emphasis or nuance that makes a substantial difference to meaning. . . . Prudent people protect themselves against the limitations of memory (and the temptation to shade the truth) by limiting their dealings to those memorialized in writing" (Rissman, 2000).

Enhancing the Realizable Value of Knowledge Assets and other Resources

The sources of firm value and future growth opportunities are many and varied (Kester, 1984). It is, however, increasingly difficult to identify significant sources of firm value wherein legal rights are not important factors in realizing that value. Just as management's ability to develop and utilize information

technology applications to enhance and support other business functions may be a source of sustained competitive advantage (Mata, Fuerst, & Barney, 1995), so might management's ability to use the law effectively to protect, realize, and leverage the value of other firm resources.

Management of knowledge assets, such as capabilities and business processes, can determine the company's ability to survive, adapt, and to compete (Leonard, 1998), and it has significant legal dimensions that remain largely unexplored in the relevant literatures. Intellectual property law provides managers with various techniques to realize the value of knowledge. These include copyrighting works; patenting inventions and processes to erect barriers to entry, reduce costs, and generate revenues; and protecting tacit knowledge and other proprietary information as trade secrets.

Intellectual property rights can be used both offensively to shut down a competing line of business, as happened when Polaroid used its patents to shut down Kodak's instant camera and film business (Ingrassia & Hirsch, 1990) and defensively as bargaining chips (as happened when Amgen and Chiron settled their interleukin-2 patent infringement case by giving each other cross-licenses (Bagley, 2002). Microsoft's ability to maintain its margins in excess of 90% is directly related to its ability to use copyright law to prevent the unauthorized copying of its products. IBM earned \$1.5 billion in licensing fees and patent royalties in 2001 (Gerstner, Jr., 2002), offering a way for IBM to capture the value of the discoveries it did not have the ability to commercialize. Licensing also distributed IBM's technology more broadly and increased its ability to influence the development of industry standards and protocols (Gerstner, Jr., 2002). IBM then went a step further and began selling technology components to other companies in hopes of positioning IBM to benefit from the growth of businesses outside the computer industry that will rely on components to power new networked digital devices (Gerstner, Jr., 2002).

The paths available to a firm include the increasing returns available to firms with proprietary technologies (Teece, Pisano, & Shuen, 1997). For example, Xerox successfully defended its refusal to sell replacement parts for its copiers to independent service organizations (ISOs) by patenting the parts and announcing its policy at the time the copiers were sold (Bagley & Clarkson, 2003, 2004). In contrast, Kodak's policy of not selling replacement parts was struck down as an illegal tie in part because Kodak had changed its policy retroactively after consumers had already purchased capital-intensive copiers with a long useful life and in part because Kodak's parts manager testified at trial that patents never crossed his mind when the company adopted a policy not to sell to independent service providers (Bagley & Clarkson, 2003, 2004). A legally astute parts manager would have understood the permissible scope of Kodak's patent protection and

been able to testify truthfully about Kodak's desire to exercise its legal right to exploit the value of its patents.

A firm's position includes customer lists protectible as trade secrets and other intellectual property assets (Teece, Pisano, & Shuen, 1997). Properly crafted covenants not to compete can prevent knowledge workers—the individuals “who know how to allocate knowledge to productive use, just as the capitalists know how to allocate capital to productive use” (Drucker, 1993: 8)—from taking their “tools of production” to rival firms. Under the emerging doctrine of inevitable disclosure, an employer may be able to prevent a former employee from working for a competitor, even in the absence of a covenant not to compete, if the new position would result in the inevitable disclosure or use of the former employer's trade secrets (*PepsiCo, Inc.*, 1995).

Like failure to implement the correct corporate governance practices (Barney, Wright, & Ketchum, 2001), failure to implement appropriate legal measures can prevent firms from fully realizing the benefits of the other resources they control. For example, proprietary technology not adequately protected as a trade secret or by a patent (Jaffe & Lerner, 2004) is no longer unique to the firm that developed it.

Of course, no one piece of intellectual property will provide sustained competitive advantage. Firms that try to lock in their customers may lose them instead (Malone, Yates, & Benjamin, 1989). Firms in turbulent environments must continuously innovate and remake themselves to fit changing market and technological conditions. Indeed, it is important for firms to ensure that their desire to protect their existing intellectual property does not blind them to “disruptive technologies” (Christensen, 1997). One must wonder whether Polaroid's fixation on winning its instant camera and film patent case against Kodak might have distracted it from addressing the threats and opportunities posed by digital photography.

Converting Regulatory Constraints into Opportunities

Failure to comply with applicable law can impose added costs, foreclose markets, and jeopardize the franchise. Convicted firms earned significantly lower returns on assets than unconvicted firms (Baucus & Baucus, 1997). In addition to the direct costs of sanctions (such as fines and punitive damages) and the legal costs associated with litigation and appeals, illegality can divert funds from strategic investments, tarnish a firm's image with customers and other stakeholders, raise capital costs, and reduce sales volume (Baucus & Baucus, 1997). Organizations that have adequate procedures in place to ensure compliance with law should generate higher returns than firms that have not implemented such practices.

At the outer bounds, failure to comply with the law can threaten the very existence and continued viability of a firm. The demise of Drexel Burnham Lambert in the late 1980s as a result of insider trading and other types of securities fraud, of Barings Bank in 1995 in the wake of rogue trading by Nick Leeson, and of Enron Corporation in 2002 after massive accounting fraud are but three examples of this phenomenon.

Because a regulatory change can affect an industry's structure, "a company must ask itself, 'Are there any government actions on the horizon that may influence some elements of the structure of my industry? If so, what does the change do for my relative strategic position, and how can I prepare to deal with it effectively now?'" (Porter, 1980).

Regulation may provide unforeseen opportunities for profits by forcing firms to innovate (Mitnick, 1980; Porter & van der Linde, 1995). Proactive strategies for dealing with the interface between a firm's business and the natural environment that went beyond environmental regulatory compliance were associated with improved financial performance (Judge & Douglas, 1998; Klassen & Whybark, 1999). Yet, firms' ability to reduce pollution became a source of competitive advantage only after they replaced the mindset of reducing pollution to meet government end-pipe restrictions with a search for ways to use environment-friendly policies to create value (Nehrt, 1998; Reinhardt, 1998; Reinhardt, 2000). Similarly, a "prospector" bank that viewed the requirements of the Community Reinvestment Act (CRA) as "an 'opportunity' to do more than was required and a 'responsibility' as a leader of the community" successfully adjusted to a tougher regulatory environment and developed innovative and profitable products to appeal to theretofore underserved lower-income strata (Fox-Wolfgramm, Boal, & Hunt, 1998). Thus, at least under certain circumstances, the ability to proactively go beyond the letter of the law can result in competitive advantage.

Framing is critical here. The categorization of an issue as an opportunity or a threat can affect the decision maker's subsequent cognitions, motivations, level of risk taking, involvement, and commitment (Thomas, Clark, & Gioia, 1993; Gilbert, 2006). Legally astute management teams practice what I call "strategic compliance management." They view the cost of complying with government regulations as an investment, not an expense. Instead of just complying with the letter of the law, they seek out and embrace operational changes that will enable them to convert regulatory constraints into innovation opportunities.

ORGANIZATIONAL CONSIDERATIONS

In environments in which a high degree of legal astuteness is needed, it may be necessary to form what Clark and Wheelwright (1992) call "heavyweight

teams,” comprising managers and in-house lawyers. Nelson and Nielsen (2000) found that roughly 25% of the responding in-house counsel were members of senior management, based on their titles. Because the functional backgrounds of the top managers and power relations are related to a firm’s strategy (Finkelstein, 1992), the inclusion of lawyers in the top management team can be expected to affect the alternatives and the strategic choices considered (Tushman & Romanelli, 1985). Bringing together individuals, such as lawyers and managers, from “different ‘thought-worlds” may increase access to historical perspectives and multiple functional areas (Ancona & Caldwell, 1992: 323), enhance problem solving by widening scanning activities (Keck, 1997), and reduce group-think by prompting greater disagreement (Miller, Burke, & Glick, 1997), but at the cost of increasing team conflict and head butting as different people use their own specialized languages, images, and stories (Miller, Burke, & Glick, 1997). It may also decrease interpersonal communication and reduce perceived effectiveness (Keck, 1997).

To achieve “internal integration” (Clark & Wheelwright, 1992), problem solving must be tightly connected across departmental boundaries and the costs associated with functional diversity must be overcome (Ancona & Caldwell, 1992). It is clear that “simply changing the structure of teams (i.e., combining representatives of diverse function and tenure) will not improve performance. The team must find a way to garner the positive process effects of diversity and to reduce the negative direct effects” (Ancona & Caldwell, 1992: 338). To bridge this kind of professional gap (Senge, 1990), managers and counsel must learn how to make explicit the key assumptions underlying their reasoning and engage in meaningful face-to-face interactions with others to address complex and conflicting issues. Decisions in one function can then take into account the skills and concerns of the other function (Baldwin & Clark, 1992: 70–71). This paper posits that legally astute management teams will be better equipped to garner the advantages of this functional diversity than teams lacking that capability.

Lawyer-CEOs

In certain environments, where the firm faces legal uncertainties and contingencies that affect resources critical to the firm’s survival, boards may select lawyers to serve as chief executive officers (Pfeffer & Salancik, 2003). In recent years, the number of CEOs who began their careers as lawyers has increased by 100% (Kim, 2001). Priest and Rothman (1985) attributed the increased percentage of chief executives with law backgrounds – from 15.6% in 1955 to 22.2% in 1970 – to “an increasing legalistic corporate organizational environment and increasing litigation involving corporations” (1985: 135). Indeed, the selection of a lawyer as CEO may be seen as a signal that the firm is

facing more serious legal problems than previously acknowledged (Porter, Lorsch, & Nohria, 2004).

Lawyer-CEOs who advise themselves on legal issues of importance often have fools for clients. They lack the ability to be objective and may overestimate their expertise in a given area, especially those that are evolving rapidly. The landmark case of *Smith v. Van Gorkom* (1985), in which the lawyer-CEO wrongly concluded there was no need for the selling company to reserve the right to accept a better deal, is a prime example of the danger of advising oneself about legal matters of great importance.

The Dangers of Cooption

We know that the relentless focus on performance can lead managers to make decisions that result in violations of law that can put the firm's continued viability at risk. A lawyer is an officer of the court charged with advising clients concerning the law and the steps necessary to comply with it. When representing a client, a lawyer is required to "exercise independent professional judgment and render candid advice" (American Bar Association, 2002: 70). There is a risk that including lawyers on management teams will result in their being "coopted" by the nonlawyer managers and thereby lose their objectivity. In particular, "[T]o the extent that general counsel participates at an early stage in shaping major transactions and corporate policy, counsel's ability to bring detached, professional judgment to bear in assessing their legality may be compromised, especially when the question of legality is tinged in shades of gray as opposed to black and white" (De Mott, 2005). De Mott cited the convictions of both 76-year-old Franklin C. Brown, former general counsel of Rite Aid, for fraudulently concealing the drugstore chain's illegal accounting practices and the former general counsel of Inso Corp. for perjury and the guilty pleas by the former general counsel of Computer Associates and U.S. Wireless as examples of the perils of the solidarity that can develop between a general counsel and other members of senior management. Auerbach (1984) argued that this potential loss of objectivity makes it inappropriate for inside counsel to be involved in strategic planning unless the plans are vetted by independent outside counsel. The risk of cooption may be particularly acute for the "many lawyers [who] actively seek to join the ranks of senior management and leave the legal department altogether" (Kim, 2001: 206).

This problem of cooption may make it necessary to ensure that certain in-house and outside lawyers are kept separate from the top management team so they can objectively evaluate the legality of proposed actions. This important monitoring function is akin to that performed by internal and external auditors. Thus, it may be appropriate to locate in-house lawyers geographically near the business units for purposes of contract negotiation and most other legal matters, but to centralize regulatory functions, such as antitrust, environmental, and

securities law compliance, at the firm's executive headquarters to avoid undue identification with any given business unit. If the general counsel is a member of the top management team, then it may be necessary for the board of directors to appoint a senior lawyer who reports directly to the audit committee to act as an independent chief compliance officer. A separate compliance staff would appear especially important for firms with a high degree of legal astuteness.

There is precedent for this separation of the legal and compliance functions. In response to late trading and other scandals, the SEC adopted regulations requiring registered investment companies to appoint a chief compliance officer who reports directly to the board. The SEC staff has cautioned against housing the chief compliance officer or the compliance staff in the legal department (Richards, 2004).

Firms could also enhance objectivity by following the recommendation of Bevis Longstreth (2006: 32), former commissioner of the Securities Exchange Commission and partner of the law firm Debevoise & Plimpton, and require all outside lawyers who have billed the corporation more than \$50,000 in legal fees to meet at least twice annually with a legal committee comprising independent directors without the presence of management to discuss "the legal issues the lawyers have been retained to address, the nature of unusual constraints imposed on their work, the nature of their relationship with management, the range of legal risks involved in each matter they have worked on, the advice given to management with respect to those risks and management's reaction, the nature of any red flag observed and other matters relating to their services that may be important to the Committee."

LEGAL ASTUTENESS AND FIRM PERFORMANCE

This paper posits that the value of legal astuteness will vary depending on both the firm's strategic posture and its external environment. Firms that attain a degree of legal astuteness that "fits" with their strategic posture and their external environment should realize greater value from this managerial capability than those that do not. In certain contexts, legal astuteness may provide sustained competitive advantage.

Strategic Posture

Extrapolating from the contingency approach to strategic human resource management (SHRM) (Youndt, Snell, Dean, & Lepak, 1996), I propose that the impact on firm performance of actively managing the legal aspects of business is moderated by the firm's strategic posture. Each different strategic orientation implies a different approach to the use of legal tools, and it may require a different degree of legal astuteness. The more central legal considerations are to the firm's value proposition, the greater the need for legal astuteness. For

example, strong intellectual property protection would appear to be more important for a firm that pursues a strategy of product differentiation than for one pursuing a low-cost strategy that does not rely upon the existence of proprietary technologies. Strategic compliance management may be more important for firms that use reputation to differentiate their products than for those that sell based on low cost.

The importance of using formal contracts as complements to relational governance will also vary. In certain settings, such as the New York diamond industry (Macaulay, 1963), a request for a formal contract is so atypical as to be tantamount to a renunciation of the preexisting relationship. Adversarial negotiations in which the lawyer seeks to win points by negotiating the toughest deal possible for the client may be appropriate for discrete transactions with clear and readily verifiable outputs. For example, if a firm is pursuing a low-cost strategy, based on just-in-time inventory management, and can obtain commodity parts from a variety of suppliers, it may be appropriate to negotiate the lowest price per unit possible and to specify and enforce stiff penalties for failure to deliver on time. But if a firm's low-cost strategy is based on the firm's ability to outsource its service obligations, which are uncertain and may change over time, then creating a relationship of trust may be more important than specifying tough remedies for default.

There is anecdotal evidence that managers do in fact choose lawyers with different negotiating styles depending on the importance of relationship-building. For example, a manager interviewed by Nelson and Nielsen (2000: 481) reported using a "hard-line" lawyer to protect her back in tough negotiations with another large corporation, but selecting a "very soft attorney" who was more relationship-oriented and low key to renew a solid and successful relationship with another company.

External Environment

The value of legal astuteness can also be expected to vary over time as conditions in the firm's environment changes. As Pfeffer and Salancik (2003: 46) explained, "A lawyer may be relatively unimportant until the organization is confronted with a major lawsuit that threatens its survival." Legal astuteness may be particularly valuable in turbulent and in "Red Queen" hypercompetitive environments where competition is fluid and opponents make it impossible for any given firm to attain a static sustainable advantage (D'Aveni, 1994), because it offers the top management team a wider array of options in response to unpredictable environmental developments. Like the relationship between TMT tenure (Finkelstein & Hambrick, 1990) and TMT size and CEO dominance (Haleblian & Finkelstein, 1993) on the one hand and firm performance on the other, the relationship between legal astuteness and firm performance should be more significant in high-discretion environments (Hambrick & Finkelstein, 1987)

characterized by environmental munificence and dynamism (Goll & Rasheed, 1996), than in low-discretion environments.

Legal Astuteness as a Source of Competitive Advantage

To the extent that legal astuteness can empirically be shown to be not only valuable but also rare, nonsubstitutable, and difficult to imitate, it may be a source of competitive advantage under the resource-based view of the firm (Barney, 1991). Because the effective management of the legal dimensions of business is based on socially complex relations between lawyers and the other nonlawyer managers in a firm, the capability of legal astuteness would appear to be firm-specific and not subject to low-cost imitation. There are no apparent ready substitutes, but its rarity is an empirical question that to date is unanswered.

As is the case with SHRM (Mahoney & Pandriam, 1992; Wright, Smart, & McMahan, 1995; Delery & Doty, 1996; Wright & Snell, 1998), competitive advantage may be more readily obtained when a firm's legal strategy is effectively matched with its business strategy. Consider the practice of at-will employment in the United States whereby an employee may be terminated by the employer at any time for any or no reason. Pfeffer (1994) cautions that the practices lawyers tend to recommend to ensure at-will status, such as avoiding references to job security or career paths, are "almost completely antithetical to what an organization would do to achieve competitive advantage through its work force" (Pfeffer, 1994: 147). This suggests that managers who view their employees as sources of competitive advantage should be especially careful not to delegate responsibility for setting their human resources policies to their lawyers. Instead, Pfeffer suggests, the managers in such firms should consider offering employment security and providing internal ways of resolving disputes rather than relying on the legal system. Legally astute management teams would appear to be better equipped to integrate legal considerations into a consistent overall firm strategy.

CONCLUSION

This paper introduced the construct of legal astuteness and argued that it is a valuable dynamic managerial capability. More theoretical work is clearly needed to deepen and refine the theory. Additional theoretical and empirical work is also needed to determine whether and under what circumstances legal astuteness can result in sustained competitive advantage. Interviews, surveys, and other field methods, such as those used by Eisenhardt and Bourgeois (1988) and Knight, Pearce, Smith, Olian, Sims, Smith, and Flood (1999), may be particularly good ways to test the theory.

As with the study of multinational enterprises (Sundaram & Black, 1992), multidisciplinary and integrative theory-building and research will be necessary in order for researchers to accurately and comprehensively understand the legal dimensions of management. Legal scholars need to join forces with researchers in the fields of organizational behavior, strategy, institutional economics, political science, and business history to understand more fully the interface of law and management and the role of legal astuteness in the achievement and sustainability of competitive advantage. My hope is that this paper has helped lay the theoretical predicate for further work in this area.

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