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What's Law Got to Do with It: A Systems Approach to Management

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Abstract

This paper embeds legal considerations in mainstream management theory and frameworks. It proposes a systems approach to law and management that explains how law affects the competitive environment, the firm's resources, and the activities in the value chain. This is a dynamic model that recognizes that firms and markets are part of a broader system of society and that managerial actions will affect the law and how it is interpreted and applied over time. The paper suggests that the ability of managers to communicate effectively with counsel and to work together to solve complex problems and leverage the resource advantages of the firm—what this paper refers to as "legal astuteness"—may in certain contexts be a dynamic capability providing competitive advantage. A key objective of the paper is to spark greater academic interest in the legal aspects of management and to provide a theoretical predicate for multi-disciplinary empirical work on the role of law and legal astuteness in the achievement and sustainability of competitive advantage.

INTRODUCTION

Governments matter (Ring, Bigley, D'Aunno, & Khanna, 2005). Public law—the formal rules embodied in constitutions, statutes enacted by legislatures, judicial decisions rendered by courts, and regulations promulgated by administrative agencies—establishes the rules of the game (North, 1990) for managers striving to create value and to capture some or all of it for the firm. (Although informal rules and customs may also affect a firm's ability to create or capture value, they are beyond the scope of this paper.)

Law affects each of the "five forces" (Porter, 1980) that determine the state of competition in an industry (Shell, 2004). Because government regulation can dramatically affect the environment within which firms do business (Schuler, 1996; Shaffer, 1995), it is important for managers to develop a corporate strategy for political action (Aggarwal, 2001; Baron, 1995; Hillman and Hitt, 1999; Keim & Zeithaml, 1986; Shell 2004; Yoffie & Bergenstein, 1985). This often includes lobbying and working directly with regulatory bodies (Yoffie, 1987). Under certain circumstances, a particular political strategy may result in sustained competitive advantage under the resource-based view of the firm (Hillman & Hitt, 1999).

Governments do more than regulate and constrain (Edelman & Suchman, 1997), however. Laws liberate individual action (Commons, 1970) and enhance firm legitimacy (DiMaggio & Powell, 1983). They also facilitate interorganizational interactions (Pearce, 2001). For example, the availability of a limited partnership as a form for organizing a venture capital fund and of convertible preferred stock, with a variety of rights, preferences and privileges, were key to the growth of the U.S. venture capital industry (Sahlman, 1990).

Managers can use a variety of legal tools to create value and manage risk (Bagley, 2000) and to lower costs or enhance differentiation (Siedel, 2002). These include employment contracts, proprietary information agreements, stock options, and technology licenses (Suchman, Steward, & Westfall, 2001). For example, venture capitalists often use restricted stock and stock options to align the incentives of the management team with those of the investors (Gompers & Lerner, 2001). Such arrangements can decrease the agency costs (Jensen & Meckling, 1976) arising out of the separation of ownership and control.

This paper seeks to provide a more complete picture of the role of law in management by integrating this earlier work with an analysis of the effect of law on the resources (Barney, 1991) and capabilities of the firm (Teece, Pisano, & Shuen, 1997) and on the activities in the value chain (Porter, 1990). It builds on the insight that managers must take regulatory and ethical factors into account when devising a corporate strategy (Baron, 1995; Yoffie & Bergenstein, 1985) but extends it to all of the legal aspects of business. The systems approach to law and management embeds legal considerations in an integrated model that marries the resource-based view of the firm and the dynamic capabilities approach with the concepts of a value chain, the five forces, and the context for firm strategy and rivalry (Porter, 1996a: 211-212). This is a dynamic model that reflects the fact that managerial actions will affect society and the law and how the law is interpreted and applied over time.

This paper first summarizes briefly the existing literature on the role of law and institutions in creating efficient markets and economic prosperity. It then moves from the macroeconomic level to the level of the firm and describes the existing theory on the ability of managers to help shape their political and regulatory environment. It then highlights certain of the legal aspects of three "generic strategies": low total cost, product leadership, and customer lock-in. The paper then presents the systems approach to law and management. It concludes by suggesting that "legal astuteness"—the ability of managers to communicate effectively with counsel and to work together to solve complex problems and leverage the resource advantages of the firm—may in certain contexts be a dynamic capability providing competitive advantage.

THE NEW INSTITUTIONAL ECONOMICS

As North (1990), Williamson (1985), and other representatives of the new institutional economics movement have made clear, the specialization and division of labor necessary for impersonal exchange requires secure property rights so parties can contract across space and time (North & Weingast, 1989). Enforceable and transferable property rights make it possible to convert "dead assets" into capital (de Soto, 2000).

Certain scholars characterize contracts as part of the market environment (see, e.g., Baron, 2003; Aggarwal, 2001), but they ignore the critical role courts play in private ordering. Market forces alone are inadequate to assure contract performance (Klein & Leffler, 1981). 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). Although managers may not take most of their contractual disputes to court (Macauly, 1962), the availability of judicial enforcement of contracts serves "as a back-up system seldom used actively, but always used passively" (Macneil, 1980: 94) to promote cooperation and the continuation of interdependence.

Multiple-country studies reveal that the efficiency of a country's capital markets is directly related to the country's institutional environment (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). As Polanyi (1944: 250) explained: "Economic history reveals that the emergence of national markets was in no way the result of the gradual and spontaneous emancipation of the economic sphere from governmental control. On the contrary, the market has been the outcome of a conscious and often violent intervention on the part of the government. . . ."

Moreover, a country's economic prosperity—measured by the per capita gross domestic product (GDP)—is directly correlated with certain legal protections (Porter, 2002). Researchers found a statistically significant relationship between per capita GDP and each of the following:

- Judicial independence
- The adequacy of legal recourse
- Police protection of business
- Demanding product standards
- Stringent environmental regulations
- Quality laws relating to information technology
- The extent of intellectual property protection
- The effectiveness of the antitrust laws (Porter, 2002).

Adequate protection of minority rights increases investment in new ventures (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). Conversely, excessive regulation, including licensing requirements and filing fees, can hamper new venture formation (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 1997).

There has been far less work done on the effect of law at the firm level. As Barney, Edwards, and Ringleb (1992: 345) pointed out, "much organizational research remains relatively naïve about the organizational implications of the law." The literatures on first mover advantage and the sustainability of competitive advantage "generally have missed the importance of the relationship between the resources of the firm and the regulatory context in which they are deployed" (Nehrt, 1998: 77). Nehrt called it "critical" for researchers to be more aware of the regulatory context within which a firm operates, arguing, "Ignoring regulatory issues may provide more elegant theory or cleaner analysis, but doing so ignores the messy reality within which managers operate" (Nehrt, 1998: 94). The goal of this paper is to help fill this gap.

To the extent that management scholars have explicitly addressed the legal aspects of business, they have tended to focus on the regulatory (Baron, 1995) and legitimizing aspects of law (Dimaggio and Powell, 1983; Suchman, 1995). For example, Barney, Edwards, and Ringleb (1992) found that exposure to liability stemming from employees' on-the-job exposure to hazardous materials made firms more likely to adopt a non-vertically integrated production system.

POLITICAL AND NONMARKET STRATEGIES

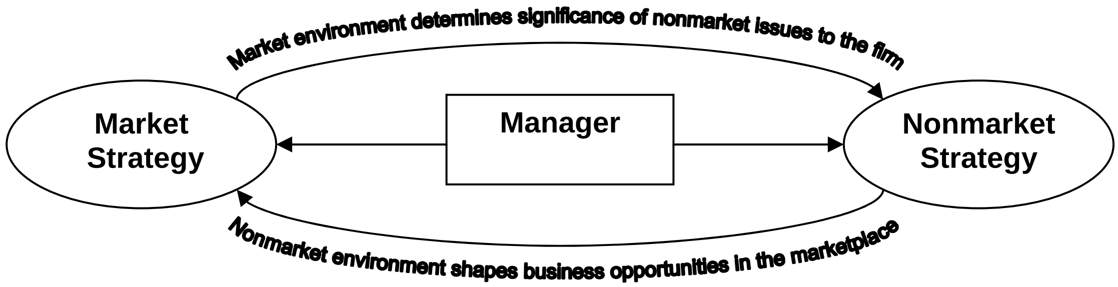
Yoffie and Bergenstein (1985) called on firms to replace ad hoc, reactive and issue-by-issue approaches to government regulation with a proactive entrepreneurial (Stevenson & Gumpert, 1985) strategy for creating and sustaining political advantage. They described MCI's successful strategy of forming the Ad Hoc Coalition for Competitive Telecommunications to handle congressional relations, having members of top management testify at public hearings, and suing AT&T for monopolization as a way of helping pry open what had been a highly regulated and closed market for communication services. In the process, MCI increased the firm's visibility and its ability to gain market share and to raise equity. MCI's business strategy and political strategy were "inextricably linked" and were both essential to the creation of MCI's multibillion dollar business (Yoffie & Bergenstein, 1985: 136).

Baron (2003) and Aggarwal (2001) distinguish between what they call the market and the nonmarket environment of business and contend that managers are responsible for formulating and implementing nonmarket as well as market strategies. Baron (1995) also highlights the importance of ensuring that the firm's "nonmarket strategy" is consistent with its "market strategy."

Baron defined "market environment" as encompassing "those interactions between firms, suppliers, and customers that are governed by markets or private agreements such as contracts" (Baron, 2003: 2). In contrast, the nonmarket environment "encompasses those interactions between the firm and individuals, interest groups, government entities, and the public that are intermediated not by markets but by public and private institutions" (Baron, 2003: 2). Nonmarket issues of importance to firms include "environmental protection, health and safety, technology policy, regulation and deregulation, human rights, international trade policy, legislative politics, regulation and antitrust, activist pressures, media coverage of business, stakeholder relations, corporate social responsibility, and ethics" (Baron, 2003: 2). Similarly, Aggarwal (2001: 91) defined the nonmarket environment as "the social, political, and legal context within which the firm operates."

Baron (1995) proposed a framework for nonmarket strategy that looks at the impact of government on business separately from the market forces then attempts to develop integrated strategies that explicitly address both market and nonmarket relationships (Ghemawat, 2001). Baron's model is depicted in Figure 1.

Figure 1 Baron's Model of Market and Nonmarket Strategies



(Baron, 2003: 3)

In contrast, Michael Porter and others have argued that "nonmarket relationships are best accounted for by folding them into the analysis of market relationships—by looking at the role of government, for instance, solely in the terms of how it shapes the five (or [if one includes the role of complementors (Brandenburger & Nalebuff, 1996)] six) forces" (Ghemawat, 2001: 35). Porter included the legal system and legal rules in his "diamond of national advantage" (Porter 1996b: 166). Porter postulates that there are four broad attributes of a nation that, individually and as a system, establish the playing field for local industries: (1) factor input conditions, such as natural and human resources; (2) demand conditions, such as the nature of the home-market demand for the industry's products; (3) the presence or absence of related and supporting industries, such as suppliers; and (4) the context for firm strategy and rivalry (Porter 1996b: 166). There are legal aspects of each (Porter, 1996a: 251).

The legal system is one of the factor conditions that firms in a given location draw upon to increase productivity. As Porter points out, "[F]irms cannot operate efficiently under onerous amounts of regulatory red tape, requiring endless dialogue with government, or under a court system that fails to resolve disputes quickly and fairly" (1996a: 210-211). Consumer protection and other laws affect the demand conditions. Land-use restrictions, building codes, tax incentives, public schools, and antitrust laws all affect related and supporting industries.

The context for firm strategy and rivalry includes the "rules, incentives, and norms governing the type and intensity of local rivalry" (Porter, 1996a: 211).

These include laws and policies affecting both (1) the climate for investment, such as the corporate governance system, labor market policies, the tax system, and intellectual property rules and enforcement, and (2) local rivalry, such as openness to trade and foreign investment, antitrust policy, and licensing rules.

By equating law with regulation and constraint, the nonmarket model ignores certain legal tools, such as intellectual property rights, that firms can use *as part of their market strategy* to affect their competitive environment and to mediate particular economic relationships. The legal tools of greatest relevance to managers will vary with both the firm's overall strategy and with the stage of development of the business. There are legal aspects of various market strategies that remain largely undeveloped in the literature.

LEGAL ASPECTS OF THREE "GENERIC" STRATEGIES

Consider three "generic" strategies: (1) low total cost, characterized by "highly competitive prices combined with consistent quality, ease and speed of purchase, and excellent, though not comprehensive, product selection"; (2) product leadership, characterized by outstanding performance, along dimensions such as speed, accuracy, size, or power consumption, that is superior to that offered by competitors' products and that is valued by leading-edge customers who are willing to pay more to receive it; and (3) customer lock-in, characterized by high switching costs, low prices to attract customers and complementors with high-margin revenues from selling secondary products and services to augment of the basic product (Kaplan & Norton, 2004: 320–326).

A firm pursuing a low total cost strategy can use business process patents and trade-secret protection to protect low-cost production and service process innovation. Properly structured contracts can create outstanding supplier relationships (Poppo & Zenger, 2002). Appropriate environmental due diligence can reduce the likelihood of a firm's being responsible for a costly clean up of hazardous waste. Attention to worker safety not only ensures compliance with the Occupational Safety and Health Act but may also reduce costly accidents. Customer releases, limitations of liability, and waivers of certain implied warranties can limit a manufacturer's liability if a product does not meet the purchaser's expectations. But often less is more. If a seller allocates risk in an objectively unreasonable manner, then a court will not enforce the bargain.

It is critical for a firm pursuing a strategy of product leadership to secure strong intellectual property protection for its innovations. Patents can be used both offensively to create barriers to entry (Porter, 1980) (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, 2005). However, "If the innovation is no more than a clever and complex assembly of relatively available technologies, then no wall of patents could keep opponents out" (Peteraf, 1993: 187). In such a case, the firm might use its head start to build other cospecialized resources that are not so readily reproduced, such as a reputation for quality service (Peteraf, 1993).

Properly crafted nondisclosure agreements help protect tacit knowledge and other valuable proprietary information as trade secrets. Assignments of inventions give the firm the ownership rights in any invention or creative work conceived of or reduced to practice by its employees. Reasonable 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).

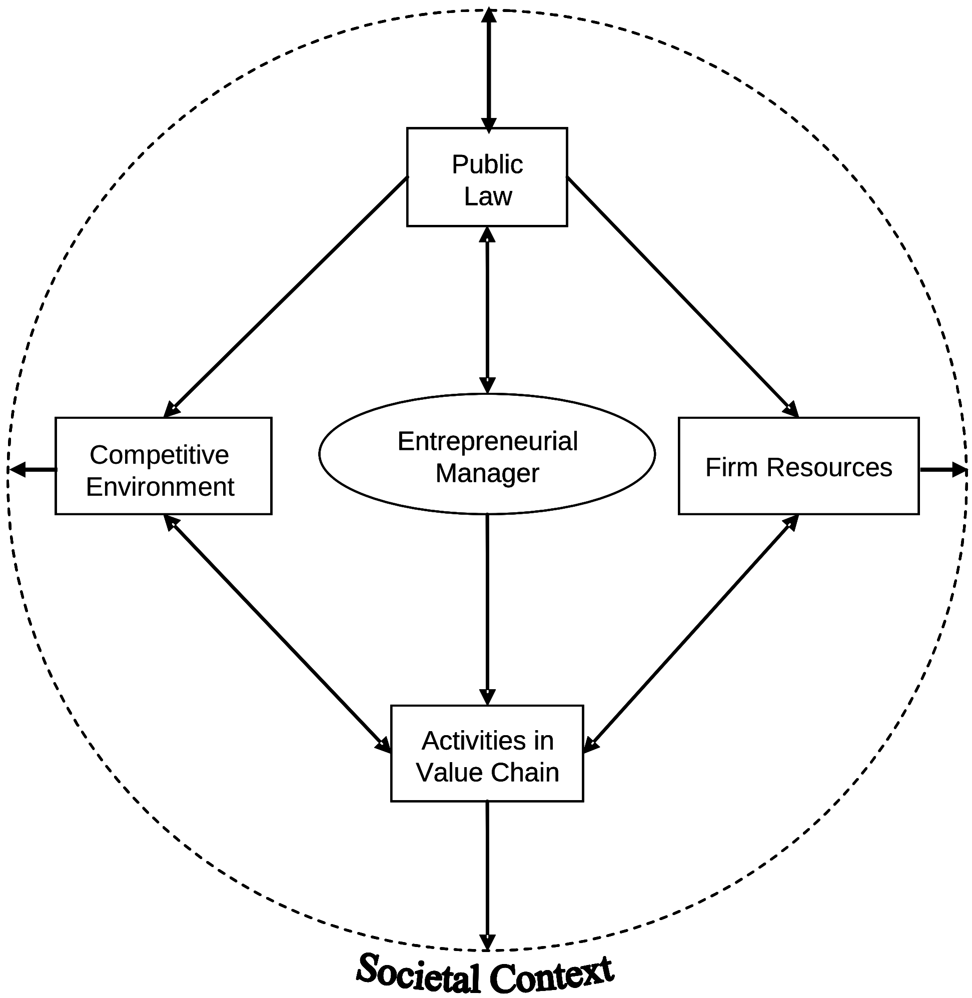
No one piece of intellectual property will provide sustained competitive advantage, however. Reverse engineering, workplace mobility, and formal and informal technical communication can make it difficult to keep proprietary information secret (Lieberman & Montgomery, 1988). Firms must continuously innovate and remake themselves to fit changing market and technological conditions (Teece et al., 1997). Managers must also 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.

A firm pursuing a lock-in strategy can secure and defend its proprietary position by obtaining patents and copyrights and by protecting trade secrets. In the United States, these proprietary rights give their owner the right to refuse to sell replacement parts to independent service organizations (Bagley & Clarkson, 2004), thereby locking customers into lucrative service contracts. In the European Union, however, this may be considered abuse of dominant position. But even in the United States, if a firm seeks to use its lawful monopoly power in one product market to obtain market power in another, then that may constitute an illegal tie. This can be particularly important in industries with high switching costs. There is a danger, however, that firms that seek to lock in their customers will lose them instead (Malone, Yates, & Benjamin, 1989) so further innovation or the reliance on secondary attributes, such as reputation, are likely to be important as well. In contrast, if a firm is able to integrate theretofore separate products to create a new product with functionalities unavailable to consumers purchasing the two products separately, then the bundle may well pass antitrust muster (Bagley & Clarkson, 2003).

A PROPOSED CONCEPTUAL FRAMEWORK FOR UNDERSTANDING THE LEGAL ASPECTS OF MANAGEMENT: THE SYSTEMS APPROACH TO LAW AND MANAGEMENT

The systems approach to law and management makes explicit the impact that law has on market forces, the resources of the firm, and the activities that comprise the value chain. It also links managerial actions to broader concerns of ethics and societal welfare. As shown in Figure 2, firms and markets are part of a broader system of society. Firm activities can affect not only the competitive environment and the value and allocation of firm resources but also the laws that regulate business and the ways they are interpreted and applied over time.

Figure 2 Systems Approach to Law and Management



At the center of this model is the entrepreneurial manager (Stevenson & Jarillo, 1990) who evaluates and pursues opportunities for value creation and capture while managing the attendant risks (Andrews, 1987). Entrepreneurial managers look for opportunities for value creation and capture without regard for the resources currently controlled (Stevenson & Jarillo, 1990: 23). Once they identify an attractive opportunity, they marshal the necessary human and capital resources to pursue it. For this purpose, the attractiveness of an opportunity will depend on the magnitude and likelihood of the reward balanced against the risks involved (Sahlman, 1999). The risk/reward profile of an opportunity will vary depending on a variety of factors, including the skills, capabilities, and desires of the managers as well as the competitive environment (Stevenson & Jarillo, 1990), including the degree of regulation or deregulation.

Public law reflects society's values and expectations and the consensus as to what constitutes acceptable behavior. It helps shape the competitive environment and affects the resources of the firm. Certain laws constrain and regulate, but others enable and provide tools that legally astute managers can use to manage the firm more effectively. Within the parameters set by the public law and given the firm's position within the competitive environment and its available resources, the manager defines the value proposition and selects and performs the activities in the value chain. As seen in Figure 3, there are legal aspects of each category in the value chain.

Figure 3 Law's Role in the Value Chain[1]

Support activities	Firm infrastructure	*Limited liability, corporate governance, choice of business entity, tax planning*
	Human resource management	*Employment contracts, at-will employment, wrongful termination, bans on discrimination, equity compensation, Fair Labor Practices Act*
	Technology development	*Intellectual property protection , nondisclosure agreements, assignments of inventions, covenants not to compete, licensing agreements*
	Procurement	*Contracts, Uniform Commercial Code, Convention on the International Sale of Goods, bankruptcy laws, securities regulation*

Inbound logistics	**Operations**	**Outbound logistics**	**Marketing and sales**	**Service**
Contracts *Antitrust limits on exclusive dealing contracts* *Environmental compliance*	*Workplace safety* *Environmental compliance* *Process patents*	*Contracts* *Environmental compliance*	*Contracts* *Uniform Commercial Code* *Convention on the International Sale of Goods* *Consumer protection laws* *Bans on deceptive or misleading advertising or sales practices* *Antitrust limits on vertical and horizontal market division, tying, and predatory pricing* *Import / export controls* *World Trade Organization*	*Strict product liability* *Warranties* *Waivers and limitations of liability* *Doctrine of unconscionability*

Primary Activities

Margin

[1] The language in italics has been added by the author to the framework set forth in Porter (1980).

For example, the decision to outsource part of the value chain (such as manufacturing or service) rather than to perform those functions internally rests on the assumption that the other firm will be legally required to perform the outsourced activity at the agreed upon price. Under certain circumstances, a firm may be able to strengthen its relationships with key suppliers by using formal contracts as complements to relational governance techniques, such as trust building (Poppo & Zenger, 2002).

The contract of sale as well as any express or implied warranties made will determine a firm's ongoing service obligations. Provisions limiting liability to replacement or repair and disclaiming liability for consequential damages can limit the seller's exposure for property damage in the event a product proves defective and will be enforced as long as they do not allocate risk in an objectively unreasonable manner.

The legal tools of greatest relevance to managers will vary with both the firm's overall strategy and with the stage of development of the business. Decisions made in the early stages can dramatically affect the courses of action available in the later stages.

Effect of Law on the "Five Forces"

As discussed in detail in Shell (2004), law affects each of the five forces Porter (1980) identified as determinants of the attractiveness of an industry: buyer power, supplier power, the competitive threat posed by current rivals, the availability of substitutes, and the threat of new entrants. For example, antitrust laws can affect a firm's ability to merge with other players. The European Commission blocked General Electric's proposed acquisition of Honeywell even though the U.S. Justice Department had approved the merger. Lawsuits challenging a competitor can be an effective way to send market signals or to voice displeasure with, for example, a competitive price cut (Porter, 1980: 85–86). However, firms must be careful that their signaling does not lead to price-fixing, market division, or other illegal collusive arrangements (Fried & Oviatt, 1989). Although it may be permissible for competitors at the same level of distribution to form patent pools or to work together to set industry standards, it is illegal for firms to fix prices or divide markets even if such arrangements are intended to enable small competitors to compete with larger firms.

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: 183–184).

Travelers Insurance and Citibank dramatically changed their regulatory environment when, with the tacit approval of Federal Reserve Board Chairman Alan Greenspan, they helped persuade Congress to amend the Glass-Stegall Act and the Bank Holding Company Act to permit commercial banks to underwrite securities and insurance (Langley, 2003; Cox, 1999; Wilmarth, 2002). The two firms merged in 2002 to form Citigroup.

Regulation may provide unforeseen opportunities for profits by forcing firms to innovate (Mitnick, 1993; Porter & van der Linde, 1995). 3M claimed that the production process changes necessary to reduce polluting emissions resulted in net savings of $10 million per year (Mitnick, 1993). 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). 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).

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).

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). Rather than treating compliance with government regulations as an additional cost, Mitnick (1980) and other scholars have called on managers to take advantage of the business opportunities provided by regulation and deregulation. The cost of compliance might therefore be better framed as an investment than as an expense.

Effect of Law on Firm Resources

The resource-based view (RBV) of the firm underscores the importance of organizational factors in the creation of competitive advantage. Firm resources, be they physical capital, human capital, or organizational capital, have the potential of providing sustained competitive advantage if they are valuable, rare, and imperfectly imitable by competitors, and have no strategically equivalent substitutes (Barney, 1991).

The market environment, through opportunities and threats, determines the value of firm resources (Priem & Butler, 2001: 22). Although the firm is the unit of analysis under the resource-based view, "a complete model of strategic advantage would require the full integration of the models of the competitive environment (i.e., product market models) with models of firm resources (i.e., factor market models)" (Barney, 2001: 49). This paper asserts that a complete model would have to include the legal and societal context as well.

Failure to implement appropriate legal measures can prevent firms from fully realizing the benefits of the other resources they control. Illegal conduct can put a firm at a competitive disadvantage. 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).

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.

On the upside, law can be used to leverage other firm resources in a variety of ways. 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: 498), so might management's ability to use the law effectively to realize and leverage the value of other firm resources. As discussed earlier, intellectual property law provides managers with various techniques to realize the value of the knowledge assets, which can determine the company's ability to survive, adapt, and compete (Leonard, 1998).

The ability to license patented inventions offers another way to capture the value of innovation. IBM earned $1.5 billion in licensing fees and patent royalties in 2001 (Gerstner, 2002). IBM was not commercializing various types of technology it had developed in the 1970s and 1980s for fear of "cannibalizing IBM existing products, especially the mainframe, or working with other industry suppliers to commercialize new technology"(Gerstner, 2002: 149). Licensing provided a way to capture the value of the discoveries that IBM did not have the ability to commercialize. It also distributed IBM's technology more broadly and increased its ability to influence the development of industry standards and protocols (Gerstner, 2002).

Laws permitting employment at-will while requiring the payment of damages for wrongful termination and banning employment discrimination affect the firm's ability to marshal human resources, as do laws enforcing or prohibiting certain noncompete agreements. Laws offering limited liability to investors, giving entrepreneurs fresh starts under the bankruptcy laws, and promoting transparency in the capital markets facilitate the marshaling of financial capital. Finally, corporate law affects the allocation of firm resources among stakeholders. Antitakeover and constituency statutes shift power from the shareholders to the board of directors by giving the board the ability to block a proposed change of control or sale of assets favored by the shareholders.

Societal Context, Change, and Ambiguity

Law is not static. It evolves in response to changing societal needs and expectations and new technologies. Courts in a common law jurisdiction, such as the United States and England, will often change the law to reflect evolving notions of duty. As the Texas Supreme Court explained when it first held employers potentially liable for an accident caused by an intoxicated employee ordered to leave the premises, "Courts will find a duty when reasonable men agree that it exists" (*Otis Engineering Corporation v. Clark*, 1983).

As noted earlier, managers can engage in lobbying and other political activities to change the public law and the way it is interpreted and applied. Other firm activities will affect the broader society and may prompt changes in the public law. New laws enacted in response to corporate misdeeds, such as accounting fraud in the case of the Sarbanes-Oxley Act of 2002 and massive bribery in the case of the Foreign Corrupt Practices Act in 1978, often impose greater restrictions and costs on business than would have been imposed had firms acted more responsibly at the outset.

The way law is interpreted also changes over time. Even if the wording of a statute or regulation remains the same, juries and judges bring ethical and social considerations to bear when interpreting and applying the law (American Bar Association, 2002: 70). Law is rarely applied in a vacuum and its application to a given set of facts is often not clear-cut. 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. Legal inference is often highly ambiguous (Langevoort & Rasmussen, 1997) and "moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied" (American Bar Association, 2002: 70). There are large gray areas. As a result, "legal inference is often characterized by high ambiguity" (Langevoort & Rasmussen, 1997: 423). As U.S. Supreme Court Justice Oliver Wendell Holmes explained, legal advice is often just a prediction of what a judge and jury will do in a future case (Holmes, 1897: 457). As a result, any manager making decisions with legal implications must deal with ambiguity and exercise a degree of judgment.

Failure to meet society's expectations of appropriate behavior (Kaplan and Norton, 2004) or to treat stakeholders fairly (Jensen, 2001) can jeopardize a firm's ability to compete effectively. Managers must wrestle with the "moral aspects of choice" when examining and choosing among the alternatives available (Learned, Christensen, Andrews, & Guth, 1969: 578). As a result, meeting changing societal expectations is part of every manager's job.

IMPLICATIONS FOR MANAGEMENT THEORY AND PRACTICE

The systems approach has certain implications for management practice and theory. If one accepts the fact that law helps shape the competitive environment, that it affects the value and allocation of firm resources as well as the selection and performance of the activities in the value chain, then managers who can exert control over the legal dimensions of business should be better able to shape the competitive environment and to select and perform that set of activities most likely to create sustained competitive advantage. Hinthorne (1996: 251) presented three examples from the airline 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." In particular, managers who can communicate effectively with counsel and work together to solve complex problems and to integrate legal considerations into the formulation and execution of strategy—what this paper calls the managerial capability of "legal astuteness"—should be better equipped to protect and leverage firm resources. Thus, legal astuteness is arguably a valuable managerial and organizational process under the dynamic capabilities approach (Teece et al; 1997).

Dynamic Capabilities Approach

Teece, Pisano and Shuen developed the dynamic capabilities approach to explain how and why certain firms build competitive advantage in "a Schumpeterian world of innovation-based competition, price/performance rivalry, increasing returns, and the 'creative destruction' of existing competencies" (1997: 509). They pointed out that well-known companies, such as IBM, Philips, and Texas Instruments, "appear to have followed a 'resource-based strategy' of accumulating valuable technology assets, often guarded by an aggressive intellectual property stance," but this strategy is often not enough to generate sustained competitive advantage (Teece et al., 1997: 515). Instead, they asserted, "Winners in the global marketplace have been 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" (Teece et al., 1997: 515).

The dynamic capabilities approach postulates that "the competitive advantage of firms lies with its managerial and organizational process, shaped by its (specific) asset position, and the paths available to it" (Teece et al., 1997: 518). There are legal dimensions of each.

Process

A firm's managerial and organizational process includes (1) the ways managers coordinate or integrate activity inside the firm, including routines for gathering and processing information, for linking customer experiences with engineering design choices, and for coordinating factories and component suppliers; (2) the process by which learning occurs and is disseminated, which depends on the joint contributions to the understanding of complex problems made possible by common modes of communication and coordinated search procedures; and (3) the capacity to reconfigure the firm's asset structure and to accomplish the necessary internal and external transformation (Teece et al., 1997: 518–521). A firm's process to obtain, integrate, deploy, and reconfigure resources (Eisenhardt & Martin, 2000) makes it possible for a firm to modify and renew what otherwise might be a transient competitive advantage (Rindova & Kotha, 2001).

Legally astute managers recognize the importance of law to firm success and appreciate the importance of selecting a true counselor at law who combines knowledge of the law with judgment and wisdom (in the words of Kronman (1995: 132-133), a "legal statesman"). Rather than seeking merely technical legal advice, legally astute managers call on their lawyers to refer to moral, economic, social, and political factors when giving advice. At the end of the day, as long as counsel has not advised that a particular course of action is illegal, the legally astute manager accepts responsibility for deciding whether a particular risk is worth taking or a particular opportunity is worth pursuing. For example, legally astute managers understand that every legal dispute is a business problem requiring a business solution (Bagley, 2000). They accept responsibility for managing their disputes and do not hand them off to the lawyer with a "you take care of it" approach.

The more central legal considerations are to the firm's value proposition, the greater the need for legal astuteness. 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 and Salancik, 2003). (Lest they have fools for clients, lawyer-CEOs should not advise themselves on legal issues of importance.)

Instead of viewing legal considerations as an after-thought or add-on to the firm's business strategy, legally astute managers include legal constraints and opportunities at each stage of strategy formulation and execution. They 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 bring in counsel early in the cycle of decision-making. They also understand the importance of anticipating tomorrow's laws and of trying to predict how existing laws may be interpreted and enforced in the future.

Scholars posit that a proactive environmental strategy that "anticipate[s] future regulations and social trends and design[s] or alter[s] operations, processes, and products to prevent (rather than merely ameliorate) negative environmental impacts" is a dynamic capability that can offer competitive advantage (Aragon-Correa & Sharma, 2003). The continuum of approaches to managing the interface between business and the natural environment—which ranges from a reactive posture that responds "to changes in environmental regulations and stakeholder pressures via defensive lobbying and investments in end-of-pipe pollution control measures” to proactive postures (Aragon-Correa & Sharma, 2003)—can be extended to the interface between business and other aspects of the legal environment.

In contrast, management teams lacking the requisite degree of legal astuteness tend to 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.

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).

Managers and lawyers employ distinct mental models, which impedes their ability to take advantage of each other’s area of expertise. As Daft and Lengel succinctly put it: “a person trained as a scientist may have a difficult time understanding the point of view of a lawyer” (1986: 564). The same is true of a person trained as a manager.

Bringing together individuals 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, 1998), 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, 1998). It may also decrease interpersonal communication and reduce perceived effectiveness (Keck, 1997). 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. Because effective management of the legal dimensions of business is based on socially complex relations between lawyers and the other nonlawyer managers in a firm, they are not easily transferable to other firms or subject to low-cost imitation.

There is, however, a danger that lawyers who work closely with or become part of the top management team will be "coopted" by the managers and thereby lose their objectivity. When representing a client, a lawyer is required to "exercise independent professional judgment and render candid advice" (American Bar Association, 2002: 70). A lawyer is an officer of the court charged with advising clients concerning the law and the steps necessary to comply with it. A variety of corporate scandals that resulted in the destruction of billions of dollars of value, ranging from the savings and loan crisis in the 1980s (Simon, 1998) to the fall of Enron and WorldCom in 2002, resulted in part from lawyers' inability or unwillingness to insist that their clients comply with the law.

Position

A firm's position consists of its "current specific endowments of technology, intellectual property, complementary assets, customer base, and its external relations with suppliers and complementors" (Teece et al., 1997: 518). Firm position includes the firm's product market position, which, as discussed earlier, is shaped in part by legal factors. Position also includes the firm's financial and reputational assets, which can be impaired by compliance failures. The realizable value of a firm's technological assets will depend in part on the legal rights attached to them. For example, customer lists are protectible as trade secrets if they are kept confidential.

Position includes structural assets, such as distinctive governance models and choice of business entity, which will determine whether the investors have limited or unlimited liability; how active investors can be in managing the firm without losing limited liability; how easily transferable ownership interests are; whether tax is paid at just the owner level or at the firm level as well; and how power is allocated between the managers and the equity holders. Regulatory systems and institutional assets—such as an independent judiciary and legislature bounded by a constitution; administrative agencies with the power to enact regulations, to adjudicate disputes, and to enforce laws; intellectual property regimes; and tort and product liability laws—also comprise part of the firm's position (Teece et al., 1997).

A firm's position also includes enforceable rights, including contracts (Teece et al., 1997). Long-term contracts can protect a seller from the instability that can result from dependence on a single critical supplier (Pfeffer & Salancik, 2003). An earn-out arrangement in connection with the sale of a business can offer a way to address information asymmetry, risk, and uncertainty (Gilson, 1984). Covenants in partnership agreements establishing venture capital funds can help protect investors from opportunistic behavior by the fund managers (Gompers & Lerner, 1996). Courts enforce the private rules embodied in contracts between the firm and its employees, customers, investors, suppliers, and others, as long as they do not conflict with the public policies embodied in the public law.

Paths

A firm's paths are "the strategic alternatives available to the firm, and the presence or absence of increasing returns and attendant path dependencies" (Teece et al., 1997: 518). Paths include the increasing returns available to firms with proprietary technologies. 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 that Kodak's patents "never crossed his mind" when he changed Kodak's replacement-parts policy (Bagley & Clarkson, 2003, 2004).

Paths also include the firm's history of legal compliance and its ethical traditions. A convicted firm is more likely to violate again than a firm that has never been convicted (Baucus & Near, 1991).

Conclusion

This paper embedded legal considerations in mainstream management theory to explain how law affects the competitive environment, the resources of the firm, and the activities in the value chain. It showed that the appropriate use of counsel and legal tools can expand the range of options available to management teams as they evaluate and pursue opportunities for value creation and capture while seeking to manage the attendant risks. Accordingly, at least in some contexts, legal astuteness may be a dynamic capability offering competitive advantage.

A key objective of this paper is to provide a theoretical predicate for empirical research on the role of law in the achievement and sustainability of competitive advantage. Research questions include: Are there certain industries in which legal considerations are more important than others? In what contexts can legal astuteness be a source of competitive advantage? What organizational structures are best suited to achieving the benefits of legal astuteness? For example, when should the chief legal officer be a member of the top management team? How do firms prevent in-house lawyers from being coopted by non-lawyer managers? An empirical examination of such questions will test the model presented in this paper and will most likely require its further refinement.

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