"What's Law Got to Do with It: Integrating Law and Strategy"

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March 28, 2010

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An earlier version of this paper was presented at the Annual Meeting of the Academy of Management in 2005.

Abstract

This paper presents a comprehensive integrated model of law and strategy. It weaves together the traditional approach to the nonmarket environment with Porter's five forces, the resource-based view of the firm and the activities in the value chain to explain how law affects the competitive environment and the value and uniqueness of firm resources. This paper builds on earlier work postulating that "legal astuteness" is a valuable managerial capability and identifies the characteristics necessary for legal astuteness to be a source of sustained competition advantage.

I. INTRODUCTION

Although scholars have long recognized the role firms can play in shaping government regulation through lobbying and other political activities, [1] the theoretical and empirical work on the strategic value of actively managing the legal dimensions of business is far less developed. Because a failure to comply with applicable laws can subject a firm to crushing government fines and ruinous damage awards and put its top executives in prison, any discussion of law and strategy must begin with the baseline of what is illegal behavior.[2] Yet, staying out of trouble is only part of the picture. Managers who view the law purely as a constraint, something to comply with and react to rather than to use proactively, will miss opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm.[3]

Siedel reported on executives' own perceptions of the relative importance of a course in business law in 2000,[4] and Bagley asserted that managers could use the law to

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[1] *See, e.g.,* BRUCE M. OWENS & RONALD BRAEUTIGAN, THE REGULATION GAME: STRATEGIC USE OF THE ADMINISTRATIVE PROCESS (1978); David B. Yoffie & Sigrid Bergenstein, *Creating Political Advantage: The Rise of The Corporate Political Entrepreneur*, 28(1) CAL. MGMT. REV. 124 (1985); Gerald D. Keim & Carl P. Zeithaml, *Corporate Political Strategy and Legislative Decision Making: A Review and Contingency Approach*, 11 ACAD. MGMT. REV. 828 (1986); David B. Yoffie, *Corporate Strategy for Political Action: A Rational Model*, *in* BUSINESS STRATEGY AND PUBLIC POLICY 92-111 (A. March, A. Kaufman & D. Beam eds., 1987); Barry M. Mitnick, *The Strategic Uses of Regulation – and Deregulation*, *in* CORPORATE POLITICAL AGENDA: THE CONSTRUCTION OF COMPETITION IN PUBLIC AFFAIRS (Barry M. Mitnick, ed. 1993); David P. Baron, *Integrated Strategy: Market and Nonmarket Components*, 37(2) CAL. MGMT. REV. 47 (1995); B. Shaffer, *Firm-Level Responses to Government Regulation: Theoretical Approaches*, 21 J. MGMT. 495 (1995); D. Schuler, *Corporate Political Strategy and Foreign Competition: The Case of the Steel Industry*, 39 ACAD. MGMT. J. 720 (1996); Amy Hillman & Michael Hitt, *Corporate Political Strategy Formulation: A Model of Approach, Participation, and Strategy Decision*, 24 ACAD. MGMT. REV. 825 (1999); Vinod Aggarwal, *Corporate Market and Nonmarket Strategies in Asia: A Conceptual Framework*, 3 BUS. & POLITICS 89 (2001); G. RICHARD SHELL, MAKE THE RULES OR YOUR RIVALS WILL (2004).

[2] CONSTANCE E. BAGLEY, WINNING LEGALLY: HOW TO USE THE LAW TO CREATE VALUE, MARSHAL RESOURCES, AND MANAGE RISK 47-50 (2005).

[3] Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378 (2008).

[4] George J. Siedel, *Six Forces and the Legal Environment of Business: The Relative Value of Business Law Among Business School Core Courses*, 37 AM. BUS. L.J. 717 (2000).

create value later that year.[5] In 2002, Siedel published a more detailed analysis of how managers could use law for competitive advantage.[6] Two years later, Shell applied Michael Porter's five forces framework for analyzing industries and competitors[7] to the legal environment.[8] In 2008, Bagley applied the resource-based view of the firm[9] to the management of the legal dimensions of business, positing that a managerial capability she dubbed "legal astuteness" is a valuable managerial capability that may be a source of sustained competitive advantage.[10] Later that year, Bird identified five behaviors managers engage in when using law to attain competitive advantage.[11]

This paper seeks to integrate these early conceptual strands into a comprehensive theory of law and strategy. It begins by summarizing the existing literature on the ability of managers to help shape their political and regulatory environment and to craft institutional arrangements, such as firms and contracts, to privately govern their trading relationships. It then makes explicit the enabling aspects of law inherent in Porter's five-forces framework,[12] various "generic" strategies,[13] the value chain,[14] and the resource-based view of the firm.[15] This paper then integrates this prior work into a comprehensive

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[5] Constance E. Bagley, *Legal Problems Showing a Way to Do Business*, FIN. TIMES, Nov. 27, 2000, at 2.
[6] GEORGE J. SIEDEL, USING THE LAW FOR COMPETITIVE ADVANTAGE (2002).
[7] MICHAEL E. PORTER, COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS (1980); *see also* Michael E. Porter, *How Competitive Forces Shape Strategy*, *in* MICHAEL E. PORTER, ON COMPETITION 21 (1996).
[8] SHELL, *supra* note 1.
[9] Jay B. Barney, *Firm Resources and Sustained Competitive Advantage*, 17 J. MGMT. 99 (1991). *See also* Birger Wernerfelt, *A Resource-Based View of the Firm*, 5 STRAT. MGMT. REV. 171 (1984).
[10] Bagley, *supra* note 3.
[11] Robert C. Bird, *Pathways of Legal Strategy*, 14 STAN. J.L., BUS., & FIN. 1 (2008).
[12] PORTER (1980), *supra* note 7.
[13] ROBERT KAPLAN & DAVID NORTON, STRATEGY MAPS (2004).
[14] MICHAEL E. PORTER, COMPETITIVE ADVANTAGE: CREATING AND SUSTAINING SUPERIOR PERFORMANCE (1990).
[15] Barney, *supra* note 9; Bagley, *supra* note 3. *See also* David J. Teece, Gary Pisano, & Amy Shuen, *Dynamic Capabilities and Strategic Management*, 18 STRAT. MGMT. J. 509 (1997).

model of law and strategy and concludes with a discussion of the circumstances under which legal astuteness can be a source of sustained competitive advantage.

II. POLITICAL AND NONMARKET STRATEGIES

Preston and Post posit that "there is an inherently interactive and symbiotic relationship between the private business organization and the larger society that constitutes its host environment."[16] Thus, "the organization and the environment are parts of a complex interactive system."[17] "[A]nticipating, understanding, evaluating and responding to public policy developments within the host environment" is accordingly "itself a critical managerial task."[18] As Justice Stevens put it in his dissent in *Citizens United v. Federal Election Commission*, "Business corporations must engage the political process in instrumental terms if they are to maximize shareholder value."[19]

Yoffie and Bergenstein called on firms to replace ad hoc, reactive and issue-by-issue approaches to government regulation with a proactive entrepreneurial strategy for creating and sustaining political advantage. They discussed 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.

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[16] LEE E. PRESTON & JAMES E. POST, PRIVATE MANAGEMENT AND PUBLIC POLICY: THE PRINCIPLE OF PUBLIC RESPONSIBILITY 12 (1975).
[17] Kalman J. Cohen & Richard M. Cyert, *Strategy: Formulation, Implementation and Monitoring*, J. BUS. 352 (1973).
[18] PRESTON & POST, *supra* note 16, at 4.

MCI's business strategy and political strategy were "inextricably linked" and were both essential to the creation of MCI's multibillion dollar business.[20] Although Bird[21] is correct in pointing out that smaller firms often do not have the resources to lobby effectively, the MCI example shows how a new entrant can help change the rules to the detriment of a much larger incumbent.

Baron proposed a framework for "nonmarket strategy" that looks at the impact of government on business separately from market forces then attempts to develop integrated strategies that explicitly address both market and nonmarket relationships.[22] Like Yoffie and Bergenstein,[23] Baron highlighted the importance of ensuring that the firm's "nonmarket strategy" is consistent with its "market strategy" in the course of analyzing Kodak's attempt to use U.S. trade regulation as a way to compete more effectively with Fuji Film. Hillman and Hitt focused on the process of political strategy formulation by which firms can shape government policy and thus their own competitive space and proposed a model for understanding which political strategy is most likely to result in sustained competitive advantage under the resource-based view of the firm. [24]

Baron and others[25] distinguish between what they call the market and the nonmarket environment. Baron defines "market environment" as encompassing "those interactions between firms, suppliers, and customers that are governed by markets or

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[19] 130 S. Ct. 876, 963 (2010).
[20] Yoffie & Bergenstein, *supra* note 1, at 136.
[21] Bird, *supra* note 11.
[22] Baron, *supra* note 1. See also David Baron, *Integrated Market and Nonmarket Strategies in Client and Interest Group Politics*, 1 BUS. & POLITICS 7 (1999).
[23] Yoffie & Bergenstein, *supra* note 1.
[24] Hillman & Hitt, *supra* note 1.
[25] *See, e.g.,* Aggarwal, *supra* note 1.

private agreements such as contracts."[26] 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."[27] 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."[28] Similarly, Aggarwal defined the nonmarket environment as "the social, political, and legal context within which the firm operates."[29]

Economists and historians have described the role of law and political institutions, such as courts, in fostering economic growth and the development of markets. According to North and Weingast, "one necessary condition for the creation of modern economies dependent on specialization and division of labor (and hence impersonal exchange) is the ability to engage in secure contracting across time and space."[30] In the absence of law and order, protection of property, and enforcement of contracts, "few people will habitually take risks to improve on what they have."[31]

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[26] DAVID BARON, BUSINESS AND ITS ENVIRONMENT 2 (2003). As discussed further below, given the role of the judicial sanction in private ordering, *see, e.g.,* IAN R. MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS (1980), it seems incorrect to characterize contracts as part of the market environment.
[27] *Id.*
[28] *Id.*
[29] Aggarwal, *supra* note 1, at 91.
[30] Douglass North & Barry Weingast, *Constitutions and Commitments: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. ECON. HISTORY 803, 831 (1989). *See also* JOHN R. COMMONS, LEGAL FOUNDATIONS OF CAPITALISM (1924).
[31] Theodore J. Lowi, *Risks and Rights in the History of American Governments*, 119(4) DAEDALUS 17 (1990). The World Economic Forum reported in 2002 that for all 75 countries studied there was a statistically significant relationship between a country's Gross Domestic Product (GDP) per capita—"the best single, summary means of current competitiveness available across all countries"—and each of the following: (1) judicial independence, (2) the adequacy of legal recourse, (3) police protection of business, (4) demanding product standards, (5) stringent environmental regulations, (6) quality laws relating to

Coase[32] underscored the importance of stable yet adaptive rules, which make it possible for individuals and firms to calculate economic risk and reward. According to North, "Institutions reduce uncertainty by providing a structure to everyday life."[33] They "define and limit the set of choices of individuals" by prohibiting certain activities and setting forth the conditions under which individuals are permitted to undertake certain activities.[34]

North and other representatives of the new institutional economics movement use the term "institutional environment" to include both formal, explicit rules, such as constitutions, laws, and property rights, as well as informal, often implicit rules, such as conventions, norms of behavior, and codes of conduct.[35] They distinguish the *institutional environment*, which establishes "the rules of the game," from *institutional arrangements*, which are the specific guidelines trading partners design to mediate particular economic relationships. These include the organization of the firm, contracts, and private dispute resolution. Yet, because the alternative to private dispute resolution is often the courts, bargaining typically takes place "in the shadow of the law."[36]

Baron's term "nonmarket environment" appears to be largely analogous to what North referred to as the institutional environment. Yet his framework is largely silent on how intellectual property rights and other "manager-made law" affects the internal organization of the firm, market forces, and the value captured by the firm. Thus, neither

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information technology, (7) the extent of intellectual property protection, and (8) the effectiveness of the antitrust laws. Michael E. Porter, *Enhancing the Microeconomic Foundations of Prosperity: The Current Competitiveness Index in World Economic Forum*, in THE COMPETITIVENESS REPORT 2001-2002 59-61 (Michael E. Porter, ed. 2002).

[32] RONALD H. COASE, THE FIRM, THE MARKET AND THE LAW (1988).

[33] DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (1990).

[34] *Id.* at 3-4.

[35] *Id.* at 36.

Baron's work on nonmarket strategies nor Yoffie's[37] and Yoffie and Bergenstein's[38] work on political strategies appear to capture the role of institutional arrangements in the formation and implementation of the firm's business strategy.

Transaction cost economics (TCE) focuses on the boundaries of the firm—the decision of which transactions should be vertically integrated into the firm and subjected to the firm's governance arrangements and which should be governed by interorganizational contracts. The literature on transactions costs emphasizes that opportunism may cause parties who have entered into an agreed-upon exchange to break their promises. According to Williamson, "Rather than reply to opportunism in kind, the wise [bargaining party] is one who seeks both to give and receive 'credible commitments.' Incentives may be realized and/or superior governance structures within which to organize transactions may be devised."[39]

In response to exchange hazards, particularly those associated with uncertainty, specialized asset investments, and difficult performance measurement, "managers may craft complex contracts that define remedies for foreseeable contingencies or specify processes for resolving unforeseeable outcomes. When such contracts are too costly to craft and enforce, managers may choose to vertically integrate."[40] Thus, the ideal

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[36] Robert D. Cooter, Stephen Marks, & Robert H. Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEG. STUDIES 225 (1982).
[37] Yoffie, *supra* note 1.
[38] Yoffie & Bergenstein, *supra* note 1.
[39] OLIVER E.WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS AND RELATIONAL CONTRACTING 48-49 (1985).
[40] Laura Poppo & Todd Zenger, *Do Formal Contracts and Relational Governance Function as Substitutes or Complements?,* 23 STRAT. MGMT. J. 707 (2002).

structure is the one that best addresses such exchange hazards and other legal liabilities.[41] Lawyers can create value by serving as "transaction cost engineers."[42]

Yet some scholars have argued that transaction cost economics "overstates the desirability of either integration or explicit contractual safeguards in exchange settings commonly labeled as hazardous."[43] The economic analysis of social norms draws on game theory for the proposition that "one-shot games with inefficient solutions, such as prisoner's dilemma, often have efficient solutions when repeated between the same players."[44] Thus kin groups such as tribes "can solve problems of internal cooperation without relying upon state law."[45] Trade organizations—such as the medieval law merchants, modern diamond exchanges and commodity trading associations—can offer the opportunity for repeated interaction.[46] Cooter argues that "law should ideally correct failures in the 'market for social norms,' rather like regulations should ideally correct failures in the market for commodities."[47]

Instead of just relying on formal contracts, the parties in interorganizational exchanges typically engage in repeated exchanges that are embedded in social relationships. Relational governance scholars argue that relational norms, such as trust, serve "as substitutes for complex, explicit contracts or vertical integration."[48] The values and agreed-upon processes found in social relationships may minimize transaction costs

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[41] *See* Jay B. Barney, Frances L. Edwards, & Al H. Ringleb, *Organizational Responses to Legal Liability: Employee Exposure to Hazardous Materials, Vertical Integration, and Small Firm Production,* 35 ACAD. MGMT. J. 328 (1992).
[42] Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239 (1984).
[43] Poppo & Zenger, *supra* note 40.
[44] Robert D. Cooter, *The Law and Economics of Anthropology, in* ENCYCLOPEDIA OF LAW AND ECONOMICS 723 (Boudewijn Bouckaert & Gerrit De Geest eds., 1999).
[45] *Id.*
[46] *Id.*
[47] *Id.*

as compared with formal contracts.[49] Thus, "trust and its underlying normative behaviors operate as a self-enforcing safeguard that is a more effective and less costly alternative to both contracts and vertical integration."[50] Indeed, "some contend that formal contracts may even undermine a firm's capacity to develop relational governance,"[51] by signaling distrust of the other party and thereby encouraging opportunistic behavior.[52]

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. Contrary to the assertion that formal contracts undermine relational governance, they argued, "The presence of 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."[53] 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. This is consistent with one lawyer's statement that he was "sick of being told, 'we can

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[48] Poppo & Zenger, *supra* note 40, at 708.
[49] Jeffrey Dyer, *Effective Interfirm Collaboration: How Firms Minimize Transaction Costs and Maximize Transaction Value*, 40 STRAT. MGT. J. 687 (1997); Jeffrey Dyer & Harbir Singh, *The Relational View and Cooperative Strategy and Sources of Interorganizational Competitive Strategy and Sources of Interorganizational Competitive Advantage*, 23 ACAD. MGMT. REV. 660 (1998).
[50] Poppo & Zenger, *supra* note 40, at 707. *See also* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contract Performance*, 89 J. POL. ECON. 615 (1981); C. Hill, *Cooperation, Opportunism, and the Invisible Hand: Implications for Transaction Cost Theory*, 15 ACAD. MGMT. REV. 500 (1990); ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991).
[51] Poppo & Zenger, *supra* note 40.
[52] *Id.*, citing Sumantra Ghoshal & Peter Moran, *Bad for Practice: A Critique of the Transaction Cost Theory*, 21 ACAD. MGMT. REV. 13 (1996); Stewart Macauly, *Non-Contractual Relatives in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).
[53] Poppo & Zenger, *supra* note 40, at 712.

trust old Max' when the problem is not one of honesty but one of reaching an agreement that both sides understand."[54] 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.

This approach is consistent with North and Weingast's assertion that repeat play and reputation alone are insufficient to police reneging, making more complex institutional arrangements necessary. North and Weingast posit that "these institutions do not substitute for reputation-building and associated punishment strategies, but complement them."[55] This complementarity makes it important for managers and their lawyers to ensure that the process of contracting does not interfere with the social norms against opportunistic behavior and reneging.[56]

III. MAKING EXPLICIT THE ROLE OF LAW IN STRATEGY FORMULATION AND IMPLEMENTATION

Historically, business strategy scholars have not explicitly integrated both the institutional environment and institutional arrangements into their models. Nehrt points out that the literatures on first mover advantage and the sustainability of competitive advantage "generally have missed the importance of the relationship between the

[54] Quoted in Macaulay, *supra* note 52, at 58-59.
[55] North & Weingast, *supra* note 30, at 808.
[56] Bagley, *supra* note 3.

resources of the firm and the regulatory context in which they are deployed."[57] 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."[58]

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[59]] six) forces."[60] Yet, as Ghemawat cautioned, "folding non-market considerations into the analysis of market relationships tends to focus on the effects of non-market variables . . . at the expense of systematic analysis of their evolution, including efforts to influence them."[61]

The next section makes explicit the legal aspects inherent in Porter's five-forces model, various "generic" strategies, the value chain, and the resource-based view of the firm.

A. Effect of Law on the Competitive Environment

1. Porter's Five Forces

[57] Chad Nehrt, *Maintainability of First Mover Advantages When Environmental Regulations Differ Between Countries*, 23 ACAD. MGMT. REV. 77, 77 (1998).
[58] *Id*. at 94.
[59] *See* ADAM M. BRANDENBURGER & BARRY J. NALEBUFF, CO-OPETITION (1996).
[60] Pankaj Ghemewat, *Notes on Non-Market Strategy*, Harvard Business School Globalization Note Series (2002). Porter attributed his decision not to include nonmarket factors as a sixth force to the lack of a "monotonic relationship between the strength and influence of government power and the profitability of industry." Quoted in Nicholas Argyres & Anita M. McGahan, *An Interview with Michael Porter*, 16 ACAD. MGMT. EXEC. 43, 46 (2002).
[61] Ghemewat, *supra* note 60, at 35.

Porter identified five forces that determine the attractiveness of an industry: buyer power, supplier power, the competitive threat posed by current rivals, the availability of substitutes, and the threat of new entrants. [62] He then outlined strategies firms could use to alter the firm's position in the industry vis-à-vis competitors, suppliers, and buyers in order to find a position from which it could best defend against these competitive forces or influence them to its advantage.

As Shell explained in admirable detail, law affects each of these five forces.[63] For example, a patent can differentiate a product and make it more likely that a buyer will pay a premium price. It can both reduce costs and create a barrier to entry. It can also be licensed to others to generate revenue.

The context for firm strategy and rivalry includes the "rules, incentives, and norms governing the type and intensity of local rivalry."[64]Antitrust laws can affect a firm's ability to merge with or to retaliate against smaller players as well as increase the risks of aggressively seeking to grab more market share. Lawsuits challenging a competitor can be an effective way to send market signals or to voice displeasure with, for example, a competitive price cut.[65] However, firms must be careful that their signaling does not lead to price-fixing, market division, or other illegal collusive arrangements.[66]

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[62] PORTER (1990), *supra* note 7.
[63] Shell, *supra* note 1.
[64] Michael E. Porter, *Clusters and Competition*, *in* PORTER (1996), *supra* note 7, at 211.
[65] *Id.* at 85-86. *See also* Edward A. Snyder & Thomas E. Kauper, 90 MICH. L. REV. 551 (1991).
[66] Vance H. Fried, & Benjamin M. Oviatt, *Michael Porter's Missing Chapter: The Risk of Antitrust Violations*, 3 ACAD. MGMT. EXEC. 49-56 (1989).

Table 1 offers examples of how managers can use law to affect the five forces, organized by the public policies furthered by business regulation.[67] For example, PepsiCo's Frito Lay division stopped using hydrogenated oils in its potato chips and other snacks then obtained Food and Drug Administration approval to prominently label their products as having "0 Trans Fats."[68] Insurance companies reduced employers' ability to buy cheaper healthcare policies from out-of-state providers by lobbying against national healthcare reform. Federal Express successfully challenged the National Labor Relations Board's determination of who is an "employee" to overturn a vote by the Federal Express local delivery workers to join a union.[69]

Table 1: Using Law to Affect the Competitive Environment

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[67] These four policy objectives are drawn from CONSTANCE E. BAGLEY & DIANE W. SAVAGE, MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY 12 (6th ed. 2009). An earlier version of Table 1 was published in Constance E. Bagley & Douglas W. Rae, *Law and Strategy*, Yale School of Management Case 08-023 (2008).
[68] BAGLEY, *supra* note 2, at 16-17.
[69] FedEx Home Delivery v. NLRB, 563 F.3d 492 (D.C.Cir. 2009).

Porter's Five Forces

Public Policy Objectives

	Direct Competition	Threat of Entry	Substitution	Supplier Power	Buyer Power
Promote economic growth	Obtain development subsidies, tax breaks for domestic firm; litigate application of antitrust laws	Secure patents and other IP rights; lobby for protectionist tariffs to advantage domestic firms	Secure trademarks; bundle products	Enter into long-term supply contracts	Secure cost-plus government contracts and no-bid contracts from Department of Defense; enter into exclusive dealing contracts; use contracts or IP to bundle products
Protect worker interests	Restrict availability of visas needed by rivals ; lobby for tighter OSHA or FDA regulations to detriment of lesser rivals	Seek limits on overseas outsourcing	Enter into employment agreements with covenants not to compete; subject stock to vesting	Litigate definition of "employee"	Lobby for ban on products made with child or slave labor
Promote consumer welfare	Seek to outlaw competing products on safety grounds; promote expedited regulatory approval of generic drugs; disclose product ingredients and place of manufacture	Impose licensing regime; demand posting of bond by service providers	Seek to outlaw substitute products on safety grounds	Require labeling of "foreign" parts	Require purchasers to buy services from state-licensed providers
Promote public welfare	Obtain ethanol-style subsidies for firm's product; lobby for tougher environmental standards	Resist reforms designed to reduce the costs of incorporating, obtaining licenses, and issuing securities	Seek to grandfather existing products and facilities from new taxes and regulatory requirements	Lobby for reduced import duties on foreign suppliers	Lobby for domestic content requirements and higher transportation taxes; promote bans on the payment of bribes

2. Helping to Shape the Public Rules

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?'"[70]

As with other aspects of the competitive landscape that are subject to change, managers should not passively await regulatory change but should instead act responsibly to try to influence the legislators and administrative agencies responsible for shaping industry structure.[71] Mitnick called on managers to take advantage of the business opportunities provided by regulation and deregulation.[72] Investment banking powerhouses Goldman Sachs and Morgan Stanley persuaded the Federal Reserve Board to expedite their applications to become bank holding companies to bolster investor confidence and obtain access to cheap capital from the Fed's discount window.

"Regulation may 'force' innovation, providing unforeseen opportunities for profits."[73] 3M claimed that the production process changes necessary to reduce polluting emissions resulted in net savings of $10 million per year.[74] General Electric's ecomagination campaign reduced expenses by more than $100 million.[75]

Aragon-Correa and Sharma posit that a proactive environmental strategy that "anticipate[s] future regulations and social trends and design[s] or alter[s] operations,

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[70] Porter (1996), *supra* note 7, at 183–84. *See also* George J. Stigler, *The Theory of Economic Regulation*, 2(1) BELL J. ECON. & MGMT. SCI. 3 (1971); Gregory C. Shaffer, *How Business Shapes Law: A Socio-Legal Framework*, 42 CONN. L. REV. 147 (2009).
[71] MICHAEL WATKINS ET AL., WINNING THE INFLUENCE GAME (2001). See also Sharon Oster, *The Strategic Use of Regulatory Investment by Industry Sub-Groups*, ECON. INQUIRY (Oct. 1982).
[72] BARRY M. MITNICK, THE POLITICAL ECONOMY OF REGULATION: CREATING, DESIGNING AND REMOVING REGULATORY FORMS (1980).
[73] *Id.* at 71.
[74] *Id.*

processes, and products to prevent (rather than merely ameliorate) negative environmental impacts" is a dynamic capability that can offer competitive advantage.[76] According to Nehrt, firms' ability to reduce pollution became a source of competitive advantage only after firms 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.[77] Cummins Engine lobbied to prevent the Environmental Protection Agency from backing away from tighter emission controls for diesel engines in part to capture the value of its investment in cleaner engines.[78]

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.[79] The continuum of approaches to managing the interface between business and the natural environment Aragon-Correa and Sharma describe—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—can be extended to the interface between business and other aspects of the legal environment.

3. Role of Law in Five "Generic" Strategies

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[75] Martin LaMonica, *Newsmaker: Stirring GE's Ecomagination*, CNET News.com, Oct. 26, 2007.
[76] J. Alberto Aragon-Correa & Sanjay Sharma, *A Contingent Resource-Based View of Proactive Corporate Environmental Strategy,* 28 ACAD. MGMT. REV. 71, 73 (2003).
[77] Nehrt, *supra* note 57.
[78] Geoff Paradise, *Cummins up to Standards,* DAILY TELEGRAPH (Sydney, Australia), Apr. 20, 2002, at 38.
[79] William Q. Judge & Thomas J. Douglas, *Performance Implications of Incorporating Natural Environmental Issues Into The Strategic Planning Process: An Empirical Assessment*, 20 ACAD. MGMT. REV. 1015 (1998); Robert D. Klassen & D. Clay Whybark, *The Impact of Environmental Technologies on Manufacturing Performance*, 42 ACAD. MGMT. REV. 599 (1999).

Kaplan and Norton[80] are among the few management scholars to explicitly include legal and regulatory as well as social expectations within their discussion of the organizational assets necessary for an effective competitive strategy. Meeting these expectations requires compliance with national and local regulations on the environment, safety and health, employment practices, and becoming "an employer of choice" in every community in which the firm operates through community investment.[81]

Kaplan and Norton described five "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; (3) complete customer solutions, characterized by long-lasting, quality relationships with customers to whom the company sells multiple, bundled products and services tailored to their needs and provides exceptional service, both before and after the sale; (4) 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; and (5) value innovation whereby "companies achieve superior and sustainable performance along a selected set of attributes or service features that are especially preferred by large

[80] KAPLAN & NORTON, *supra* note 13.
[81] *Id.*

customer segments, while keeping costs and prices down for such superior performance by underdelivering on features not critical to customer satisfaction."[82]

Building on Kaplan and Norton's work, Table 2 sets forth a variety of legal tactics available to firms pursuing these five generic strategies.

[82] *Id.* at 320–26.

Table 2: Legal Aspects of Five "Generic" Strategies

STRATEGIES	LEGAL ASPECTS
Low Total Cost	Secure process patents and preserve trade secrets to protect low-cost production and service process innovation Enter into contracts to create outstanding supplier relationships Avoid environmental and safety incidents Contribute to communities
Product Leadership	Minimize product liability and environmental impact Secure strong intellectual property protection Require employee assignments of inventions and nondisclosure agreements Contribute to communities
Complete Customer Solutions	Gain regulatory approval for new offerings Protect customer lists as trade secrets Protect customer data and privacy Restrict employees' ability to compete Enter into contracts to strengthen customer relationship Avoid illegal ties by bundling products to create greater functionality instead of bolting two separate products together Secure intellectual property protection (especially patents, copyrights, and trade secrets) so can deny competitors the right to offer post-sale service even if have market power in primary market Contribute to communities
Lock-in	Secure and defend proprietary position by obtaining patents and copyrights and by protecting trade secrets Litigate to defend right to refuse to sell replacement parts and other refusals to deal Enforce contracts to ensure customers, suppliers, and complementors do not deviate from proprietary standard or rules of exchange Avoid illegal bundles and potential antitrust litigation
Value Innovation	Combine legal aspects for low total cost and product leadership

Siedel asserted that "law plays an important role in both reducing costs and creating value for your customers—by enabling you to offer either lower prices or products that provide unique benefits."[83] He provided examples from lawsuits dealing with product liability, workers compensation, wrongful discharge, sexual harassment, and environmental regulation to support this claim.

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 and thereby locked in customers to higher prices for service.[84] 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.[85]

B. Effect of Law on Activities in the Value Chain

As summarized in Figure 3, law, like information technology,[86] affects each activity in the value chain.

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[83] Siedel, *supra* note 6 (2002).
[84] CSU, LLC v. Xerox Corp., 203 F.3d 1322 (Fed. Cir. 2000), *cert. denied*, 531 U.S. 1143 (2001).
[85] Image Technical Services, Inc. v. Eastman Kodak Co., 125 F.3d 1195 (9th Cir. 1997), *cert. denied*, 523 U.S. 1094 (1998); *see also* Constance E. Bagley & Gavin Clarkson, *Adverse Possession for Intellectual Property: Adapting an Ancient Concept to Resolve Conflicts Between Antitrust and Intellectual Property Laws in the Information Age*, 16 HARV. J. L. & TECH. 327 (2003); Constance E. Bagley & Gavin Clarkson, *Crossing the Great Divide: Using Adverse Possession to Resolve Conflicts Between the Antitrust and Intellectual Property Regimes*, in Gary D. Libecap (ed.), *Intellectual Property and Entrepreneurship*, 15 ADVANCES IN THE STUDY OF ENTREPRENEURSHIP, INNOVATION AND ECONOMIC GROWTH 149 (2004).
[86] Michael E. Porter & Victor E. Millar, *How Information Gives You Competitive Advantage*, in PORTER (1996), *supra* note 7, at 75.

Figure 3 Law's Role in the Value Chain[87]

Support Activities						
Firm Infrastructure	*Limited liability, corporate governance, choice of business entity, tax planning, and securities regulation*					
Human resource management	*Employment contracts, at-will employment, wrongful termination, bans on discrimination, equity compensation, Fair Labor Practices Act, National Labor Relations Act, workers' compensation, and Employment Retirement Income Security Act*					
Technology development	*Intellectual property protection, nondisclosure agreements, assignments of inventions, covenants not to compete, licensing agreements, and product liability*					
Procurement	*Contracts, Uniform Commercial Code, Convention on the International Sale of Goods, bankruptcy laws, securities regulation and Foreign Corrupt Practices Act*					
	Inbound logistics	**Operations**	**Outbound logistics**	**Marketing and sales**	**Service**	
	Contracts *Antitrust limits on exclusive dealing contracts* *Environ-mental compliance*	*Workplace safety and labor relations* *Environ-mental compliance* *Process patents and trade secrets*	*Contracts* *Environ-mental compliance*	*Contracts* *Uniform Com-mercial Code* *Convention on the International Sale of Goods* *Consumer protection laws, including privacy protection* *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 unconscion-ability* *Customer privacy*	
	Primary Activities					**Margin**

[87] The author has added the words in italics to Porter's framework. An earlier version of Figure 1 was published in BAGLEY, *supra* note 2.

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. The contract of sale as well as any express or implied warranties made will determine a firm's ongoing service obligations.[88] 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.[89]

C. Role of Law and Legal Astuteness in the Resource-Based View of the Firm

The resource-based view (RBV) of the firm underscores the importance of organizational factors in the creation of competitive advantage.[90] Barney asserted that 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.[91]

The market environment, through opportunities and threats, determines the value of firm resources.[92] 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

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[88] *See, generally*, BAGLEY & SAVAGE, *supra* note 67, at 265– 69.
[89] *Id*. at 220–24.
[90] Gary S. Hansen & Birger Wernerfelt, *Determinants of Firm Performance: The Relative Importance of Economic and Organizational Factors*, 10 STRAT. MGMT. J. 399 (1989).
[91] Barney, *supra* note 9.

resources (i.e., factor market models)."[93] This paper asserts that a complete model would have to include the legal environment and the societal context as well.

Law affects (1) the allocation of firm resources among stakeholders (e.g., by allocating power between the directors and shareholders in constituency statutes[94]), (2) the environment in which resources are converted into products (e.g., by imposing strict product liability on each firm in the chain of distribution); (3) the marshaling of human resources (e.g., by providing damages for wrongful termination and banning employment discrimination[95]); (4) the marshaling of physical capital (e.g., by offering limited liability to investors, by offering entrepreneurs fresh starts under the bankruptcy laws, and by promoting transparency in the capital markets under the federal and state securities laws); and (5) the uniqueness of resources (e.g., by providing patent and trade secret protection and by enforcing certain noncompete agreements).

Like failure to implement the correct corporate governance practices,[96] failure to implement appropriate legal measures can prevent firms from fully realizing the benefits of the other resources they control.[97] The law can impose a chance of a very negative monetary return if the legal requirements are not met. This can be in the form of fines for criminal violations (such as the $875 million TAP Pharmaceuticals paid for Medicare

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[92] Richard L. Priem & John E. Butler, *Is The Resource-Based "View" A Useful Perspective For Strategic Management Research?*, 26 ACAD. MGMT. REV. 22 (2001).
[93] Jay B. Barney, *Is the Resource-Based "View" a Useful Perspective for Strategic Management Research? Yes*, 26 ACAD. MGMT. REV. 41, 49 (2001).
[94] See Anthony Bisconti, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?,* 42 LOY. L.A. L. REV. 765 (2009).
[95] Employment discrimination suits are "among the leading types of cases faced by business leaders in the United States." Erika H. James & Lynn P. Wooten, *Diversity Crisis: How Firms Manage Discrimination Lawsuits*, 49 ACAD. MGMT. J. 1103, 1103 (2006).
[96] Jay B. Barney et al., *The Resource-Based View Ten Years After: Retrospective and Prospective*, 27 J. MGMT. 625 (2001).
[97] Bagley, *supra* note 3.

fraud[98]), civil judgments (such as the $3 billion Texaco paid Pennzoil for interfering with its agreement to buy Getty Oil[99]), or a court-ordered termination of an entire line of business (such as Kodak's instant picture business, which was shut down after Kodak was found to have violated Polaroid's patents[100]).

As discussed further below, at the outer bounds, compliance failures not only destroy shareholder value but can destroy the going concern value of the firm. The demise of Barings Bank as a result of rogue trading by Nick Leeson, of Drexel, Burnham Lambert in the wake of massive insider trading and securities fraud by Michael Milken and other officers of the firm,[101] and of Arthur Andersen after its conviction for obstruction of justice are but three examples of this phenomenon.[102] Conversely, as discussed further below, firms that practice strategic compliance management may be able to attain strategic advantage.

Teece, Pisano and Shuen[103] built on the theoretical foundations provided by Schumpeter,[104] Pemrose,[105] Williamson,[106] Barney,[107] Nelson and Winter,[108] and Teece[109] and developed the "dynamic capabilities approach" to understanding how and

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[98] John P. Martin, *5 Makers of Implants to Forfeit $311 M: They Avoid Fraud Change in Case of Doctor Payoffs*, STAR-LEDGER (Newark, NJ), Sept. 28, 2007.
[99] Texaco, Inc. v. Pennzoil Co., 729 S.W. 2d 768 (Tex. Ct. App. 1987), *cert. dismissed*, 485 U.S. 994 (1988).
[100] Lawrence Ingrassia & James S. Hirsch, *Polaroid's Patent Case Award, Smaller than Anticipated, Is a Relief for Kodak*, WALL ST. J., Oct. 11, 1990.
[101] JOHN B. STEWART, DEN OF THIEVES (1991).
[102] The ultimate reversal of Arthur Andersen's conviction by the U.S. Supreme Court in *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005), came too late to save the firm. In an industry built largely on reputation and trust, an indictment can be tantamount to a death sentence.
[103] Teece, Pisano, & Shuen, *supra* note 15.
[104] J.A. SCHUMPETER, THEORY OF ECONOMIC DEVELOPMENT (1934).
[105] EDITH PENROSE, THE THEORY OF THE GROWTH OF THE FIRM (1959).
[106] OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES (1975).
[107] Jay B. Barney, *Strategic Factor Markets: Expectations, Luck and Business Strategy*, 32 MGMT. SCI. 1512-14 (1986).
[108] RICHARD NELSON & SIDNEY WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982).
[109] David J. Teece, *Technological Change and the Nature of the Firm*, *in* TECHNICAL CHANGE AND ECONOMIC THEORY 256-81 (G. Dosi et al. eds., 1988).

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."[110] 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.[111] Instead, they assert, "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."[112]

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."[113] As a result, "Companies can provide competitive advantage and generate rents only if they are based on a collection of routines, skills, and complementary assets that are difficult to imitate."[114] Under this model firms are necessary not just to avoid prohibitive contracting costs but also "because there are many types of arrangements where injecting high-powered (market-like) incentives might well be quite destructive of cooperative activity and learning."[115] As a result, "that which is distinctive cannot be bought and sold short of buying the firm itself, or one or more of its subunits."[116]

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[110] Teece, Pisano, & Shuen, *supra* note 15, at 509.
[111] *Id.* at 515.
[112] *Id.*
[113] *Id.* at 518.
[114] *Id.* at 524.
[115] *Id.* at 517.
[116] *Id*. at 518.

Baldwin and Clark cite numerous field studies that consistently demonstrate that "superior operating performance arises" when companies possess "organizational capabilities that allow them to exploit market opportunities more effectively than their competitors."[117] They formally define organizational capabilities as "combinations of human skills, organizational procedures and routines, physical assets, and systems of information and incentives that improve performance along particular dimensions." Analogous to the way a "well-designed machine increases a worker's productivity, the capability to move quickly, reduce cost, or improve quality increases a company's productivity and the value of its opportunities."[118]

"Managerial and organization process" refers to (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. [119] Bagley argued that the ability of managers to communicate effectively with counsel and to work together to solve complex problems—legal astuteness— is a valuable managerial and organization process.[120]

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[117] Carliss Y. Baldwin & Kim B. Clark, *Capabilities and Capital Investment: New Perspectives On Capital Budgeting*, J. APPLIED CORP. FIN. 5 (1992).
[118] *Id.*
[119] Teece, Pisano, & Shuen, supra note 15, at 518– 21.
[120] Bagley, *supra* note 3. Legal astuteness requires (1) a set of value-laden attitudes, (2) a proactive approach, (3) the exercise of informed judgment, and (4) context-specific knowledge of the relevant law and the appropriate application of legal tools. *Id.* at 379. Legally astute managers acknowledge the "right

Hinthorne 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 Airline's 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).[121]

"Position" refers to the firm's "current specific endowments of technology, intellectual property, complementary assets, customer base, and its external relations with suppliers and complementors."[122] These include product market position, financial and technological assets as well as reputational assets (which can be impaired by compliance failures, as discussed further below), structural assets (such as distinctive governance modes), institutional assets (such as political institutions and courts), and regulatory systems as well as intellectual property regimes, tort laws, and antitrust laws. Position includes enforceable rights, contracts with suppliers and complementors; customer lists

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and responsibility [of inside counsel] to insist upon early legal involvement in major transactions." Abram Chayes & Antonia H. Chayes, *Corporate Counsel and the Elite Law Firm*, 37 STAN. L. REV. 277, 281 (1985). They view their lawyers as partners in value creation, not as a necessary evil. BAGLEY, *supra* note 2, at 224.

[121] Tom Hinthorne, *Predatory Capitalism, Pragmatism, and Legal Positivism in the Airlines Industry*, 17 STRAT. MGMT. REV. 251, 251 (1996).

[122] Teece, Pisano, & Shuen, *supra* note 15, at 518.

protectable as trade secrets; choice of business entity, place of incorporation, and corporate governance structure; an independent judiciary and legislature bounded by constitutions; administrative agencies with the power to enact regulations, adjudicate disputes, and enforce laws; intellectual property regimes; tort and product liability laws; and the legal aspects of the firm's product market position identified above.

"Paths" refers to "the strategic alternatives available to the firm, and the presence or absence of increasing returns and attendant path dependencies."[123] Paths include the increasing returns available to firms with proprietary technologies and the firm's history of legal compliance and its ethical traditions.

Legally astute top management teams can (1) use formal contracts as complements to relational governance to reduce transaction costs and strengthen relationships, (2) protect and enhance the realizable value of knowledge assets and other firm resources, (3) use legal tools to create valuable options, and (4) practice "strategic compliance management"[124] and thereby convert regulatory constraints into opportunities.

1. Strengthening Relationships

As discussed more fully above,[125] the law makes it possible for the players to agree on their own private rules and will enforce those rules as long as they do not conflict with fundamental public policies embodied in the public rules. 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

[123] *Id.* at 518.
[124] BAGLEY, *supra* note 2, at 50.
[125] See text accompanying notes 39-56 *supra*.

in opportunistic behavior, will have a competitive advantage over those who must use more costly immediate market forces of governance (such as equity joint ventures) or hierarchical forms of governance to protect against exchange vulnerabilities, such as moral hazard, adverse selection and hold-up.[126] The process of negotiating a contract can help the parties get to know each other better, clarify their objectives and expectations, and thereby strengthen their relationship. Yet managers need to ensure that the process of reducing an agreement to writing does not create mistrust or generate ill will.[127]

Poorly structured contracts can destroy value, as evidenced by Apple Computer's 1985 license agreement with Microsoft Corporation, which gave Microsoft the right to use "the visual displays in Windows 1.0 and the named applications programs [which embodied certain aspects of the Macintosh graphical user interface] in current and future software products.[128] When Microsoft released Windows 2.03, which more closely resembled the "look and feel" of the Macintosh graphical user interface (GUI) than Windows 1.0, Apple sued Microsoft for infringing its copyrights on the Mac GUI. Microsoft asserted that the 1985 agreement entitled it to use all of the aspects of the Mac GUI embodied in Windows 1.0 in all future versions of its operating system. In response, Apple claimed that the 1985 agreement was only "a license of the interface of Windows Version 1.0 as a whole, not a license of broken out 'elements' which Microsoft could use to create a different interface, more similar to that of the Macintosh."

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[126] Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRAT. MGMT. J. 175 (1994).
[127] Danny Ertel, *Getting Past Yes: Negotiating as if Implementation Matters*, 82(11) HARV. BUS. REV. 60 (2004).
[128] Apple Computer, Inc. v. Microsoft Corp., 717 F. Supp. 1428 (N.D. Cal. 1989).

The term "visual display" was not defined in the agreement, and the court declined to give it "a specific, technical meaning." The court reasoned, "Had it been the parties' intent to limit the license to the Windows 1.0 interface, they would have known how to say so."[129]

Of the 189 aspects of the Mac GUI that Apple claimed Microsoft had infringed, the court concluded that 179 were covered by the 1985 agreement. Aside from Apple's use of a trash can for deleted files, the court ultimately concluded that none of the remaining aspects of the Mac GUI was protectible under the copyright laws.[130]

This was not the first time Microsoft CEO Bill Gates succeeded in negotiating highly favorable contract terms. When IBM first approached Gates in 1980 to write an operating system for the personal computer IBM was designing, Gates negotiated a contract that allowed Microsoft to retain the rights to MS-DOS. In the words of a prominent software executive, "I.B.M. thought they had Gates by the balls. He's just a hacker, they thought. A harmless nerd. What they actually had by the balls was an organism which has been bred for the accumulation of great power and maximum profit, the child of a lawyer, who knew the language of contracts and who just ripped those I.B.M. guys apart."[131]

2. Enhancing the Value of Knowledge Assets and Other Firm Resources

The sources of firm value and future growth opportunities are many and varied;[132] however, it is increasingly difficult to identify significant sources of firm value wherein legal rights are not important factors in realizing that value. In particular, corporate

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[129] *Id.*
[130] Apple Computer, Inc. v. Microsoft Corp., 799 F. Supp. 1006 (N.D. Cal. 1992).
[131] *Quoted in* John Seabrook, *A Reporter at Large: E-Mail from Bill*, NEW YORKER, Jan. 10, 1994.
[132] Carl W. Kester, *Today's Options for Tomorrow's Growth*, 62 HARV. BUS. REV. 153 (1984).

knowledge, capabilities, and relationships are increasingly important sources of firm value creation. Management of these strategic knowledge assets determines the company's ability to survive, adapt, and to compete[133] and has significant legal dimensions that remain largely unexplored in the relevant literatures.

The value of actively managing the legal aspects of business comes in part from the ability to attach legal protections and privileges to knowledge assets, such as capabilities and business processes. Intellectual property law provides managers with various techniques to realize the value of knowledge.[134] These include copyrighting works, patenting inventions and processes, and protecting 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) and defensively as bargaining chips (as happened when Amgen and Chiron settled their interleukin-2 patent infringement case by giving each other cross-licenses).[135]

Patents can erect barriers to entry and reduce costs. They can also be a source of revenues. IBM earned $1.5 billion in licensing fees and patent royalties in 2001.[136] 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."[137] Licensing

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[133] DOROTHY A. LEONARD, WELLSPRINGS OF KNOWLEDGE: BUILDING AND SUSTAINING THE SOURCES OF INNOVATION (1998).
[134] See Boualem Aliouat, *Patents and Trademarks: From Business Law to Legal Astuteness*, in LEGAL STRATEGIES: HOW CORPORATIONS USE LAW TO IMPROVE PERFORMANCE 293 (Antoine Masson & Mary J. Shariff, eds., 2010).
[135] CONSTANCE E. BAGLEY, MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY (4th ed. 2002).
[136] LOUIS V. GERSTNER, WHO SAYS ELEPHANTS CAN'T DANCE? (2002).
[137] *Id.*

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.[138] 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.[139]

Brand-association trademarks, such as slogans, packaging, colors, scents and shapes, increase cash flow and decrease cash flow variability.[140] Brand-association trademark activity is positively associated with return on assets, stock returns, and Tobin's q (the ratio of a firm's market value to the replacement cost of its assets).[141]

As noted earlier, intellectual property rights, taken alone, may not be sufficient to create sustained competitive advantage. They must be part of an ongoing stream of innovative products and processes. As Jay Walker, founder of Priceline.com explained, no one price of intellectual property will protect a firm from competitors.[142] Even firms with a strong product position must continually innovate.[143]

Apple Inc. coupled the innovative design of its iPod device with a well-executed trademark strategy[144] and a copyright licensing strategy that avoided the pitfalls that had filled earlier entrants, such as MP3.com.[145] Apple not only registered the iPod product

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[138] *Id.*
[139] *Id.*
[140] Alexander Krasnikov, Saurabh Mishra & David Orozco, *Evaluating the Financial Impact of Branding Using Trademarks: A Framework and Empirical Evidence*, 73 J. MKTING. 154, 161 (2009).
[141] *Id.*
[142] Michael J. Roberts & Constance E. Bagley, *Priceline.com and Microsoft (B),* Harvard Business School Case No. 802– 82 (2001).
[143] Priceline.com successfully sued Microsoft Corporation and Expedia for violating its patent on using bidder-driven commerce to sell airline seats, hotel rooms, and other services. *Id.*
[144] David Orozco & James G. Conley, *Shape of Things to Come*, WALL ST. J., May 12, 2008, at R6.
[145] Constance E. Bagley & Reed Martin, *BitTorrent*, Harvard Business School Case No. 806–169 (2004).

name as a trademark, it also registered iPod product shapes.[146] Unlike MP3.com, which made digital copies of the music on its customers' compact discs in reliance on what turned out to be an erroneous interpretation of the fair-use exemption,[147] Apple negotiated licensing contracts with the music copyright owners before offering digital downloads of that music from its iTunes store.

Table 4 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 the opportunity, through sale of the venture, an initial public offering of stock (IPO), or reinvestment and renewal.[148]

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[146] Orozco & Conley, *supra* note 144.

[147] UMG Recordings, Inc. v. MP3.com, Inc., 109 F. Supp. 2d 223 (S.D.N.Y. 2000). The fair use doctrine, codified in Section 107 of the Copyright Act of 1976, 17 U.S.C. 107, protects certain copyright infringers from liability depending on (1) the purpose and character of the use, (2) the economic effect of the use or the copyright owner, (3) the nature of the work used, and (4) the amount of the work used.

In *Sony Corp. of America v. Universal City Studios*, 464 U.S. 417 (1984), the U.S. Supreme Court held that the sale of video cassette recorders (VCRs), which viewers could use to copy television programs, did not constitute contributory infringement because the VCRs had a substantial noninfringing use, namely, private, noncommercial copying of a program for later viewing (time shifting).

MP3.com had made digital copies of the music on its customers' compact discs, which customers could access from personal computers, using the Internet, after demonstrating that they owned a copy of the music to be downloaded. The company argued that this "space shifting" was protected fair use. The U.S. District Court for the Southern District of New York rejected this argument and held MP3.com liable for direct infringement. UMG Recordings, Inc., 109 F. Supp. 2d 223 (S.D.N.Y. 2000).

[148] Stevenson, Roberts and Grousbeck broke down the entrepreneurial process into five steps: (1) evaluating the opportunity; (2) developing the business concept; (3) assessing required resources both human and capital; (4) acquiring needed resources; and (5) managing and harvesting the venture. The five stages of business development in Table 4 are based on this model with modifications to reflect the fact that very different but significant legal issues arise in the course of marshaling human resources and raising money and in the course of managing the development, production, marketing and sale of the product or service and in harvesting the venture. HOWARD H. STEVENSON, MICHAEL ROBERTS, & HAROLD I. GROUSBECK, NEW BUSINESS VENTURES AND THE ENTREPRENEUR (2d ed. 1985). Table 4 was published in BAGLEY, *supra* note 2, at 16-17.

Table 4: Legal Tools for Increasing Realizable Value While Managing Risk

Stages of Business Development

Managerial Objectives

	Evaluating Opportunity and Defining Value Proposition	Assembling Team	Raising Capital	Development, Production, Marketing and Sale of Product or Service	Harvest
Create and Capture Value	Ask whether idea is patentable or otherwise protectable; examine branding possibilities	Choose appropriate form of business entity and issue equity to founders early; structure appropriate equity incentives for employees; enter into nondisclosure agreements and assignments of inventions agreements; secure intellectual property protection	Be prepared to negotiate downside and sideways protection and upside rights for preferred stock; be prepared to subject at least some founder stock to vesting; sell stock in exempt transaction	Implement trade-secret policy; consider patent protection for new business processes and other inventions; select a strong trademark and protect it; register copyrights; enter into licensing agreements; create options to buy and sell; secure distribution rights; decide whether to buy or build, then enter into contracts	Ask whether employee vesting accelerates on an initial public offering or sale; if investor, exercise demand registration rights or board control to force IPO or sale of company; rely on exemptions for sale of restricted stock; negotiate and document arrangements with underwriter or investment banker
Manage Risk	Ask whether anyone else has rights to opportunity	Document founder arrangements and subject their shares to vesting; analyze any covenants not to compete or trade secret issues; require arbitration or mediation of disputes; comply w/ anti-discrimination laws in hiring and firing; institute harassment policy; avoid wrongful termination by documenting performance issues; caution employees on discoverability of e-mail; provide whistle-blower protection	Be prepared to make representations and warranties in stock purchase agreement w/ or w/o knowledge qualifiers; choose business entity w/ limited liability; respect corporate form to avoid piercing of corporate vei	Enter into purchase and sale contracts; impose limitations on liability and use releases; buy insurance for product liabilities; recall unsafe products; create safe workplace.; install compliance system; do due diligence before buying or leasing property to avoid environmental problems; no tying or horizontal price fixing; integrate products instead of bolting separate products; be active in finding business solutions to legal disputes; avoid misleading advertising; do tax planning; file tax returns on time and pay taxes when due	Be mindful of difference between letter of intent and contract of sale; consider entering into no shop agreements if buyer; negotiate fiduciary out if seller; disclose fully in prospectus or acquisition agreement; secure indemnity rights; perform due diligence; allocate risk of unknown; make sure board of directors is informed and disinterested; ban insider trading and police trades

3. Creating Options

Law offers a variety of tools legally astute managers can use to create valuable options.[149] An option is the right, but not the obligation, to defer a decision until a future date. [150] Examples include an option to purchase or lease real property, the right to terminate a joint venture, subjecting a founder's shares to vesting, and securing coinvestment rights in future venture-capital rounds.[151]

4. Strategic Compliance Management[152]

Although many legal tools, such as the securitization of loans, can be used to create value for multiple stakeholders and need not be "negative or nefarious,"[153] the dramatic collapse of the subprime mortgage market in 2007 and 2008 is a striking example of how issuing mortgages without proper regard for the debtor's ability to repay the loan can have disastrous effects. Similarly, although derivatives can be effective tools to manage risk, they can also be misused by activist hedge funds to evade disclosure requirements.[154] "Creative compliance"[155] and taking advantage of unintended legal

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[149] Bagley, *supra* note 3, at 386.
[150] Real options theory posits that there is value inherent in the right to defer decisions characterized by uncertainty. Bruce Kogut & Nalin Kulatilaka, *Capabilities as Real Options*, 12 ORG. SCI. 744 (2001).
[151] Vesting and coinvestment rights are discussed in CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW (3d ed. 2008).
[152] See Bagley *supra* note 2, at 50.
[153] Darcy L. MacPherson, "A Legal Strategy Case Study: Trusts in Securitization," *in* LEGAL STRATEGIES, *supra* note 134, at 267.
[154] *See, e.g.,* CSX Corp. v. Children's Investment Fund Management (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008). Hedge funds can also easily run afoul of insider trading laws. *See* Ted Kamman & Rory T. Hood, *With the Spotlight on the Financial Crisis, Regulatory Loopholes and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?,* 2009 COLUM. BUS. L. REV. 357 (2009).
[155] Doreen McBarnet & Chris Whelan, *Creative Compliance and the Defeat of Legal Control: The Magic of the Orphan Subsidiary*, in THE HUMAN FACE OF LAW (Keith Hawkins ed. 1997).

loopholes[156] can thwart the rule of law that undergirds the capitalist system. As noted earlier, strategies of noncompliance can threaten the very existence and continued viability of a firm. In the case of WorldCom, $200 billion of shareholder value was lost in fewer than twelve months, making it the largest corporate fraud in history.[157] Failure to integrate legal considerations into the development of strategy and action plans can put a firm at a competitive disadvantage.[158]

Historical evidence suggests that a significant number of large and small firms do indeed pursue a strategy of noncompliance. A study of criminal violations by Fortune 500 firms in the period from 1970 until 1980 revealed "that a surprising number of them have been involved in blatant illegalities."[159] Fifty-eight percent of the Fortune 500 firms engaged in criminal antitrust; 18 percent in bribery; 15 percent in illegal political contributions; 5 percent in tax evasion; and 4 percent in criminal fraud.[160] Although some violations may be inadvertent, "a goodly number of violations are probably the result of conscious deliberation on the part of corporate executives who believe the benefits to be obtained from violating the law outweighs the costs that might accrue to themselves and the corporation. It would be naïve to think otherwise."[161]

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[156] MacPherson, *supra* note 153.
[157] Richard Breedan, *Restoring Trust*, report to the Hon. Jed S. Rakoff, U.S. District Court for the Southern District of New York, submitted in connection with the WorldCom bankruptcy proceeding on August 26, 2003.
[158] Bagley, *supra* note 3, at 378-79.
[159] Irwin Ross, *How Lawless Are Big Companies*?, FORTUNE, Dec. 1, 1980, at 56.
[160] *Id.*
[161] MIKE H. RYAN, CARL L. SWANSEN, & ROGENE A. BUCHHOLZ, CORPORATE STRATEGY, PUBLIC POLICY AND THE FORTUNE 500: HOW AMERICA'S MAJOR CORPORATIONS INFLUENCE GOVERNMENT (1987).

A firm with three or more violations is more likely to act illegally than a firm with only one.[162] In fact, three or more prior violations may be the best predictor of illegal behavior.[163] Thus, compliance is path dependent.

Fraud can cost a typical company between 1 and 6 percent of annual sales.[164] Schnatterly asserted, "The ability to prevent fraud, or value loss through fraud, has become a potential source of competitive advantage and improved financial performance from firms in today's economy."

Becker postulates that managers make rational decisions about the benefits of engaging in illegal behavior: "The decision to engage in dubious behavior is a function of the *probability* of detection times the *cost* of punishment if detected minus the *income* that can be gained from selling [a dubious] product, all adjusted for the company's *preference for risk*."[165] Yet Baucus and Baucus caution that managers may underestimate the consequences of illegality if they focus exclusively on court-imposed penalties and immediate declines in stock prices following conviction. 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 sale volume.[166] They found that convicted firms earned significantly lower returns on assets than unconvicted firms. Multiple-conviction firms reported

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[162] Melissa S. Baucus & Janet P. Near, *Can Illegal Corporate Behavior Be Predicted: An Event History Analysis*, 34 ACAD. MGMT. J. 9 (1991).
[163] *Id.*
[164] Karen Schnatterly, *Increasing Firm Value Through Detection and Prevention of White-Collar Crime*, 24 STRAT. MGMT. J. 587 (2003).
[165] Melissa S. Baucus & David A. Baucus, *Paying the Piper: An Empirical Examination of Longer-Term Financial Consequences of Illegal Corporate Behavior*, 40 ACAD. MGMT. J. 129 (1997).
[166] *Id.*

markedly lower returns than unconvicted firms. "Thus, managers should worry about damage to a firm's reputation and strive to avoid the label of corporate wrongdoers."[167]

Of course, it is not enough for top management to give lip service to the need for corporate compliance. Especially when discussing values, "Management communicates as much by what it doesn't do or say as by what it says and does. In fact, behavioral forms of communication are apt to have more credibility than spoken or written forms."[168] Thus, "If an employee is held accountable for traditional corporate tasks whose performance will determine his success or failure, and is also urged to undertake social objectives on which his performance is not measured, the result is inevitable. Even the most well-intentioned employee will devote his time and attention to the functions on which his career progress depends."[169]

Contrary to the hypothesis that managers engage in illegal behavior when they have difficulty obtaining the resources necessary for survival,[170] Baucus and Near found that "poor performance and low slack were not associated with illegal behavior, and wrongdoing frequently occurred in munificent environments."[171] To explain these findings, Baucus and Near offered two alternative explanations for illegal corporate behavior: *opportunity* to behave illegally resulting from rules, procedures, and other control mechanisms lagging behind firm growth and *predisposition* to select illegal

[167] *Id.* at 147.
[168] PHILLIP P. DROTNING, ORGANIZING THE COMPANY FOR SOCIAL ACTION (S. Prakash Sethi ed., 1974). As former General Electric General Counsel Ben Heineman put it: "The strong call for performance with integrity at the large company meeting can be eroded by the cynical comment an executive makes at a smaller meeting, by the winks and nods that implicitly sanction improprieties, by personal actions (dishonesty, lack of candor) that contradicts company values." Ben W. Heineman, Jr., *Avoiding Integrity Land Mines*, HARV. BUS. REV. (Apr. 2007), at 100.
[169] DROTNING, *supra* note 168.
[170] Barry M. Staw & Eugene Szwajkowski, *The Scarcity-Munificence of Organizational Environments and the Commission of Illegal Acts*, 20 ADMIN. SCI. QUARTERLY 345–54 (1975).
[171] Baucus & Near, *supra* note 162.

activities because of socialization or other organizational processes. They found that firms operating in certain industries tended to engage in illegal activities and suggested that certain industry cultures may predispose managers to act illegally. They also posited that "some firms have a culture that reinforces illegal activity" by selectively recruiting and promoting employees with "personal values consistent with illegal behavior" and by socializing employees "to engage in illegal acts as a part of their normal job duties."

Consider the very different approaches Intel Corp. and Microsoft Corporation have taken to antitrust compliance. Both firms are dominant in their markets yet Intel has emerged largely unscathed from government investigations for anticompetitive behavior.[172] In contrast, Microsoft endured two multiple-year investigations by the U.S. Department of Justice and the European Commission, faced a possible court-ordered break-up, and paid billions to settle state and private lawsuits.[173] When Intel first attained significant market share, it sent lawyers to all of its facilities to educate employees about what conduct and phraseology were acceptable.[174] In contrast, Microsoft's antitrust strategy was largely shaped by Bill Gates' fear that excess attention to antitrust compliance could cause Microsoft to lose its fighting edge as IBM did.[175]

Legally astute top management teams appreciate the importance of complying with both the letter and the spirit of the law.[176] They understand that "business decisions consist of continuous, interrelated economic and moral components"[177] and that "the moral aspects of choice" are the "final component of strategy."[178]

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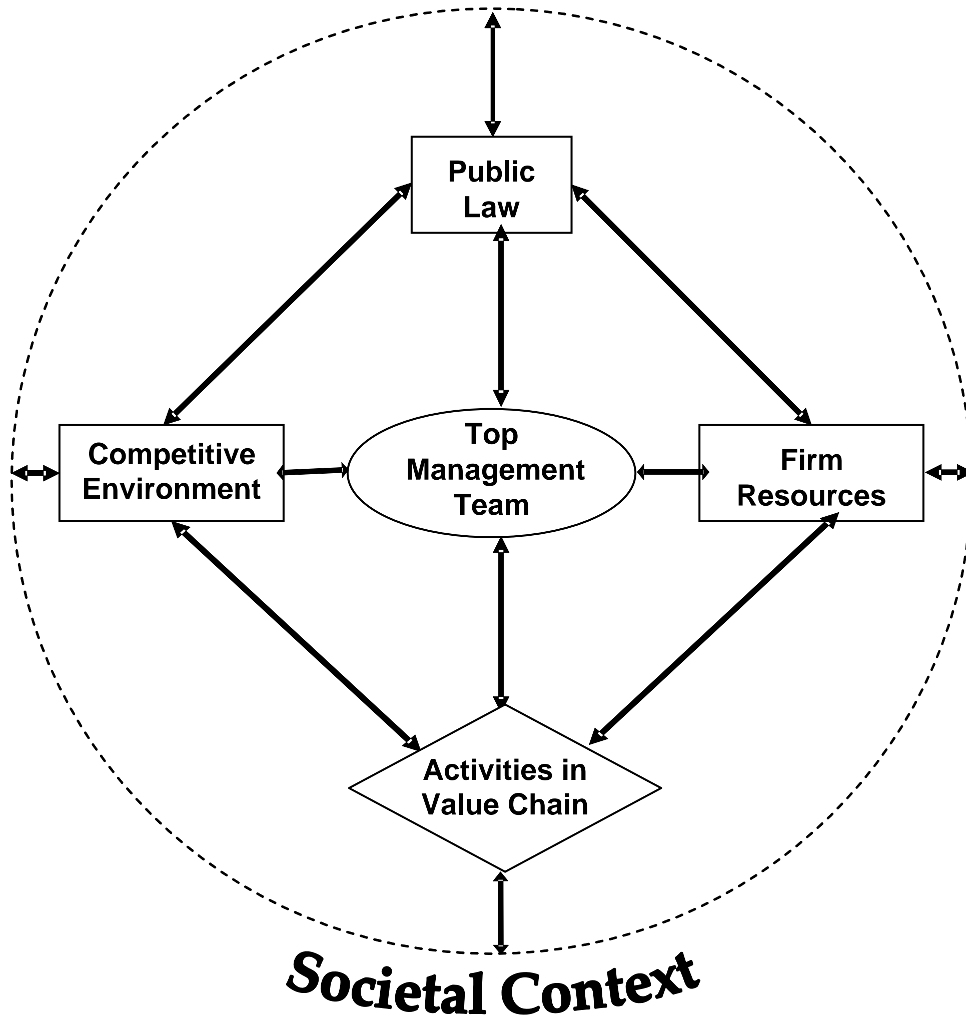
[172] Intel's antitrust winning streak may be ending. On December 16, 2009, the U.S. Federal Trade Commission announced that it was investigating Intel for allegedly engaging in anti-competitive behavior to preserve its market power.
[173] BAGLEY & SAVAGE, *supra* note 67, at 681-683.
[174] DAVID B. YOFFIE, JUDO STRATEGY (2001).
[175] Seabrook, *supra* note 131.

IV. CREATING AN INTEGRATED THEORY OF LAW AND STRATEGY

Figure 5 integrates into a coherent whole the traditional approach to the nonmarket environment and the three dominant approaches to market strategy: (1) Porter's five forces; (2) the resource-based view of the firm; and (3) the activities that comprise the value chain.[179]

[176] Bagley, *supra* note 3.
[177] Diane L. Swanson, *Addressing a Theoretical Problem in Reorienting the Corporate Social Performance Model*, 20 ACAD. MGT. REV. 43 (1995).
[178] EDMUND P. LEARNED, C. ROLAND CHRISTENSEN, KENNETH R. ANDREWS, & WILLIAM D. GUTH, BUSINESS POLICY: TEXT AND CASES 578 (1969).
[179] Figure 5 was first published in BAGLEY & SAVAGE, *supra* note 67, at 3.

Figure 5: A Proposed Conceptual Framework for Understanding Law and Strategy



At the center is the top management team, which evaluates and pursues opportunities for value creation and capture while managing the attendant risks. Within the constraints imposed by the public rules, the firm's strategic position within the competitive environment, and its resources, the top management defines the value proposition and selects and performs the activities in the value chain.

As discussed earlier, public law helps shape the competitive environment, the organization and resources of the firm, and each activity in the value chain. The system is not static, however. Public laws will change both in response to firm conduct, especially unethical behavior or managerial misconduct (as seen with passage of the Sarbanes-Oxley Act of 2002[180] in the wake of massive fraud at Enron and WorldCom[181]), and in response to the firm's lobbying and other political activities. Law and organizations are "endogenously coevolutionary."[182]

Researchers found that the ability of U.S. electric utilities to effect favorable public policy decisions over a thirteen-year period was influenced both by the internal capabilities of the firm seeking a rate increase from the state public utility commission and by the firm's regulatory and political environment.[183] Instead of trying to weaken the Foreign Corrupt Practices Act of 1978, General Electric lobbied for a global ban on bribes.[184] GE thereby both helped to eliminate the competitive disadvantage it faced when competing for government contracts with non-U.S. firms and to reduce government corruption.

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[180] Pub. L. No. 107-204, 116 Stat. 745.
[181] BAGLEY & SAVAGE, *supra* note 67, at 54-56.
[182] Lauren B. Edelman & Mark C. Suchman, *The Legal Environments of Organizations*, 23 ANN. REV. SOC. 479, 501 (1997).
[183] John-Philippe Bonardi, Guy Holburn, & Rick Vanden Bergh, *Nonmarket Strategy Performance: Evidence from U.S. Electric Utilities*, 49 ACAD. MGMT. J. 1209 (2006).
[184] BEN W. HEINEMAN, JR., HIGH PERFORMANCE WITH HIGH INTEGRITY (2008).

Public law also changes to reflect evolving societal expectations and norms. Consider the sweeping changes to credit-card and other consumer credit practices enacted in response to the credit crunch in 2008-2009[185] and the limits on executive compensation imposed on recipients of federal bailout money after AIG paid millions of dollars in bonuses.[186]

Firms are embedded within a societal context, which affects the various activities in the value chain, the competitive environment, and firm resources. "[A]n organization's survival over time often depends on its conforming to normative expectations rather than simply operating with greater efficiency."[187] Nor is simply complying with the law sufficient. As Tom Stephens, CEO of Manville Corporation put it, when explaining Manville's decision to add labels warning of the potential carcinogenic effect of fiber glass: "The laws of society are more powerful than any law that Congress can put on the books. Woe to any businessman who doesn't read the law of society and understand them."[188] Society grants powers and rights to private firms, which society can revoke if firms do not act responsibly.[189]

The "social context of resource decisions . . . affects the likelihood of optimal resource use and procurement . . . . [C]onformity to social expectations contributes to organizational success and survival."[190]

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[185] *See* Lawrence A. Cunningham, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009).
[186] Jim Puzzanghera, *Pay Czar Takes Aim at TARP Recipients*, CHI. TRIB., Mar. 24, 2010. The Federal Reserve has proposed broader restrictions on executive compensation by bank holding companies. *Proposed Guidance on Sound Incentive Compensation Policies,* 74 Fed. Reg. 55,227 (Oct. 27, 2009).
[187] Peer C. Fiss & Edward J. Zajac, *The Symbolic Management of Strategic Change: Sensegiving via Framing and Decoupling*, 40 ACAD. MGMT . J. 1173, 1173 (2006).
[188] William Glaberson, *Of Manville, Morals and Mortality*, N.Y. TIMES, Oct. 9, 1988.
[189] Donna J. Wood, *Corporate Social Performance Revisited*, 16 ACAD. MGMT. REV. 691 (1991).
[190] Christine Oliver, *Sustainable Competitive Advantage: Combining Institutional and Resource-Based Views*, 18 STRAT. MGMT. J. 697 (1997).

Firms have relationships with many constituent groups, which both affect and are affected by the actions of the firm.[191] Corporations can act as social change agents.[192]

Certain corporate social responsibility practices are sometimes associated with superior financial performance.[193] Firms may be best able to create "shared value" for the firm and society when they focus on social issues that intersect with their particular business and proposition.[194] Examples include Whole Foods Market's ability to change premium prices for healthful food products that are (1) purchased from local farmers, (2) increasingly delivered in trucks powered by biofuels, and (3) sold in stores constructed with a minimum of virgin raw materials and utilizing electricity that is offset by renewable energy credits.[195] Similarly, there is evidence that firms that promote what Jeffrey Pfeffer calls "human sustainability"— worker health and well-being by providing vacations, sick days, health insurance, training, and challenging work over which they have autonomy— outperform benchmark indices.[196] The model of law and strategy set forth in this paper should enhance managers ability to craft a truly integrated strategy for creating and capturing value for the firm while meeting the firm's responsibilities to society by enhancing managers' ability to keep societal and legal considerations "top of mind"[197] when filtering information and interpreting stimuli.

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[191] Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65 (1995).
[192] Robert J. Bies, Jean M. Bartunek, Timothy L. Fort, & Mayer N. Zald, *Introducton to Special Topic Forum: Corporations as Social Change Agents: Individual Interpersonal, Institutional, and Environmental Dynamics*, 32 ACAD. MGMT. REV. 788 (2007).
[193] Joshua Margolis & J. Walsh, *Misery Loves Company: Rethinking Social Initiatives by Business*, 48 ADMIN. SCI. QUARTERLY 268 (2003).
[194] Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, 84 HARV. BUS. REV. 78 (Dec. 2006).
[195] *Id*. at 90-91.
[196] Jeffrey Pfeffer, *Building Sustainable Organizations: The Human Factor*, 24 ACAD. MGMT. PERSPECTIVES 34, 43 (2010).
[197] *See* JAMES G. MARSH & HOWARD A. SIMON, ORGANIZATIONS (1958).

This model is also designed to help shape management research and public policy debates. Theory and ideology matter.[198] As Pfeffer points out, "[T]he struggle over the linguistic premises upon which the legitimacy of accounts will be judged"[199] affects "what we study, how we study it, and by extension, what becomes included in public policy debates as well."[200] Like failure to report environmental impact, failure to account for the externalities imposed by inadequate employee healthcare insurance, laying off workers, paying inadequate wages, and subjecting workers to overwork and stress can distort the public debate on the proper regulation of workplace conditions. We need to "broade[n] our dependent variables in management research from a focus on profitability and other indicators of firm performance, such as shareholder return and productivity on the one hand and environmental sustainability practices and social responsibility on the other, to also include organizational effects on employee health and mortality"[201] and other societal effects.

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[198] F. Ferraro, J. Pfeffer, & R.I. Sutton, *How and Why Theories Matter: A Comment on Felin and Foss*, 20 ORG. SCI. 669 (2009).
[199] H. I. Molotch & D. Boden, *Talking Social Structure: Discourse, Domination, and the Watergate Hearings*, 50 AM. SOC. REV. 272, 273 (1985).
[200] Pfeffer, *supra* note 196.
[201] *Id.* at 36.

V. CAN LEGAL ASTUTENESS BE A SOURCE OF SUSTAINED COMPETITIVE ADVANTAGE?

Legal astuteness is a valuable managerial capability[202] but does it meet the other requirements for sustained competitive environment: (1) inimitability, (2) nonsubstitutability, and (3) rarity?[203] The answer appears to be, "It depends."

A. Inimitability

Legally astute management teams call on their lawyers to play an active role in formulating the corporation's strategy as a whole instead of just acting as technical consultants brought in when the firm is confronted with a legal problem or after the management team has already decided what to do.[204] They recognize that "[b]usiness corporations do not have legal problems. They have business problems where legal considerations may be more or less important, depending on the specific circumstances."[205]

To be most effective, lawyers must understand the ins and outs of the business of the firm. This includes the tacit knowledge that often is not readily discernible by rivals.

For example, companies can use trade-secret law creatively to protect tacit knowledge. Under the emerging doctrine of inevitable disclosure, an employer may be

[202] Bagley, *supra* note 3.
[203] Barney, *supra* note 9 (1991); Margaret A. Petaraf, *The Cornerstones of Competitive Advantage: A Resource-Based View*, 14 STRAT. MGMT. J. 179 (1993).
[204] Bagley, *supra* note 3, at 380-81.
[205] MARSHALL CLINARD & PETER C. YEAGER, CORPORATE CRIME 20 (1980).

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. This doctrine was first recognized in a case involving William Redmond, Jr., a senior PepsiCo manager who left PepsiCo to work as the vice-president of field operations in Quaker's Gatorade subsidiary.[206] Redmond's high-level position gave him access to PepsiCo's strategic and operating plans for its sports drink AllSport. Redmond had signed a confidentiality agreement with PepsiCo but no covenant not to compete.

Because of the competition between AllSport and Gatorade, the court concluded that Redmond could not help but rely on PepsiCo's trade secrets as he plotted Gatorade's course. Specifically, Quaker would have a substantial advantage by knowing how PepsiCo planned to price, distribute, and market its sports drinks. The court likened the situation to that faced by a football team whose key player leaves to play for the other team and takes the play book with him. The court enjoined Redmond from working at Quaker for six months. Precedents such as these 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"[207] —from taking their "tools of production" to rival firms.

The effective management of the legal dimensions of business is based on socially complex relationships between counsel and nonlawyer managers. It requires a high

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[206] PepsiCo, Inc. v. Redmond, 54 F.3d 1262 (7th Cir. 1995). *See also* Bimbo Bakeries USA, Inc. v. Botticella, 2010 WL 571774 (E.D. Pa. Feb. 9, 2010) (applying the inevitable disclosure doctrine to the "nooks and crannies" in Thomas's English muffins).

[207] PETER DRUCKER, POST-CAPITALIST SOCIETY 69 (1993).

degree of trust, a characteristic that can itself be a source of sustained competitive advantage.[208] Moreover, because legal advice and attorney workproduct are privileged from disclosure and not usually made public, there is often significant causal ambiguity.[209]

In environments in which a high degree of legal astuteness is needed, it may be necessary to form what Clark and Wheelwright call "heavyweight teams," comprising managers and in-house lawyers. [210] Unlike representatives governed by Graham Allison's notion of "where you stand depends on where you sit,"[211] members of heavyweight teams do not just represent their functional group. Instead, they act as general managers with responsibilities for the success of the entire project.

Nelson and Nielsen found that roughly 25 percent of the responding in-house counsel were members of senior management, based on their titles.[212] Because the functional backgrounds of the top managers and power relations are related to a firm's strategy, [213] the inclusion of lawyers in the top management team can be expected to affect the alternatives and the strategic choices considered.[214]

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[208] Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 J. MGMT. 175 (1994).
[209] Causal ambiguity makes it more difficult for competitors to imitate another firm's strategy. See. Richard Reed & Robert J. DeFillippi, *Causal Ambiguity, Barriers to Imitation, and Sustainable Competitive Advantage*, 15 ACAD. MGMT. REV. 88 (1990).
[210] Kim B. Clark & Steven C. Wheelwright, *Organizing and Leading Heavyweight Development Teams*, 34(2) CAL. MGMT. REV. 9 (1992).
[211] GRAHAM ALLISON, ESSENCE OF DECISION: THE CUBAN MISSILE CRISIS (1999).
[212] Robert L. Nelson & Laura B. Nielsen, *Cops, Counsel, and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations*, 34 L. & SOC. REV. 457 (2000).
[213] Sydney Finkelstein, *Power in Top Management Teams: Dimensions, Management, and Validation*, 35 ACAD. MGMT. J. 505 (1992).
[214] Michael L. Tushman & E. Romanelli, *Organizational Evolution: A Metamorphosis Model of Conveyance and Reorientation*, in Larry L. Cummings & Barry M. Staw eds., 7 RESEARCH IN ORGANIZATIONAL BEHAVIOR 171 (1985).

Bringing together individuals, such as lawyers and managers, from "different 'thought-worlds'" may increase access to historical perspectives and multiple functional areas,[215] enhance problem solving by widening scanning activities,[216] and reduce group-think by prompting greater disagreement,[217] but at the cost of increasing team conflict and head butting as different people use their own specialized languages, images, and stories.[218] It may also decrease interpersonal communication and reduce perceived effectiveness.[219]

To achieve "internal integration," problem solving must be tightly connected across departmental boundaries[220] and the costs associated with functional diversity must be overcome.[221] 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."[222] To bridge this kind of professional gap, 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.

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[215] Deborah G. Ancona & David P. Caldwell, *Demography and Design: Predictors of New Product Team Performance*, 3 ORG. SCI. 321, 323 (1992).
[216] Sara L. Keck, *Top Management Team Structure: Differential Effects by Environmental Context*, 8 ORG. SCI. 143 (1997).
[217] C. Chet Miller, Linda M. Burke, & William H. Glick, *Cognitive Diversity Among Upper-Echelon Executives: Implications for Strategic Decision Processes*, 19 STRAT. MGMT. J. 39 (1997).
[218] *Id.*
[219] Keck, *supra* note 216.
[220] Clark & Wheelwright, *supra* note 210.
[221] Ancona & Caldwell, *supra* note 215.
[222] *Id.* at 338.

Forging such a relationship is difficult. Managers and lawyers employ distinct mental models,[223] which impedes their ability to take advantage of each other's area of professional expertise. First, managers and lawyers often have different objective goals that are a product of their training. Managers tend to focus on value creation and capture, that is, maximizing the potential upside. Lawyers tend to focus on risk management, minimizing the potential downside.[224] To work together effectively, managers and counsel must learn how to make explicit the key assumptions underlying their reasoning and how to engage in meaningful face-to-face interactions with others to address complex and conflicting issues.[225]

Managers are trained to focus on identifying opportunities and analyzing risk/reward profiles and to devise strategies for executing their business plans.[226] Lawyers, for their part, are trained by studying discreet areas of the law, such as contracts, torts, and antitrust. There are relatively few courses in law school that even attempt to teach law students to address messy business problems, which usually include a combination of legal subjects and a variety of business considerations. Although several law schools offer courses on accounting and finance, law students are rarely trained in strategy and most lawyers are not skilled managers.

Second, there is the lack of a common language. Managers and lawyers speak distinct professional dialects, further enhancing the potential for misunderstanding. To work together effectively, the lawyer and business leader must be able to understand what

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[223] CHRIS ARGYRIS, REASONING, LEARNING AND ACTION: INDIVIDUAL AND ORGANIZATIONAL (1982).
[224] MATTHEW PARSONS, EFFECTIVE KNOWLEDGE MANAGEMENT FOR LAW FIRMS (2004).
[225] PETER M. SENGE, THE FIFTH DISCIPLINE: THE ART AND PRACTICE OF THE LEARNING ORGANIZATION (1990).

the other is concerned about; they must share a common vocabulary to "typify and stabilize experiences and integrate those experiences into a meaningful whole."[227]

Consider Arthur Andersen's conviction for obstruction of justice after shredding boxes of documents relating to its audit of Enron Corporation. 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, that she was not recommending the shredding of documents.[228]

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.[229] 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.

In certain environments, where the firm faces legal uncertainties and contingencies that affect resources critical to the firm's survival, boards may select

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[226] William A. Sahlman, *Some Thoughts on Business Plans, in* THE ENTREPRENEURIAL VENTURE (William A. Sahlman et al., eds., 1999).
[227] Andrew M. Pettigrew, *On Studying Organizational Cultures*, 24 ADMIN. SCI. QUARTERLY 575 (1979).
[228] Richard A. Oppel Jr. & Kurt Eichenwald, *Arthur Andersen Fires an Executive for Enron Orders*, N. Y. TIMES, Jan. 16 2002.
[229] THOMAS A. SCHWEIGH, PROTECT YOURSELF FROM BUSINESS LAWSUITS (. . . AND LAWYERS LIKE ME) (1998).

lawyers to serve as chief executive officers.[230] In recent years, the number of CEOs who began their careers as lawyers increased by 100 percent.[231] As of 2004, 10.8 percent of the CEOs of companies in Standard & Poor's 500-stock index had law degrees.[232]

In many ways, the integration of legal considerations into business strategy and decisionmaking necessary for legal astuteness is analogous to what is now regarded as best practice for managing information technology (IT).[233] Early on, companies tended to view information technology as a black box.[234] IT issues were shuffled off to the IT department or outsourced with a "you take care of it" attitude. Information technology executives spent the majority of their careers within the information technology function, and few were likely to be involved in strategic planning and control. General managers were not expected to understand the technology, and chief executive officers and other members of top management were not expected to become personally involved in IT decisions. Senior executives felt uncomfortable making hard choices about IP yet found that they were not realizing much business value from the high-priced technology they installed.

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[230] JEFFREY PFEFFER & G.R. SALANCIK, THE EXTERNAL OF ORGANIZATIONS: RESOURCE DEPENDENCE PERSPECTIVE (2003).
[231] S.M. Kim, *Dual Identities and Dueling Obligations: Preserving Independence in Corporate Representation*, 68 TENN. L. REV.179 (2001).
[232] Mike France & Louis Lavelle, *A Compelling Case for Lawyer-CEOs*, BUS.WK., Dec. 13, 2004, at 88. Of course, having a lawyer as CEO does not necessarily insulate a firm from legal problems, as seen most recently in the case of AIG and its lawyer-CEO Maurice (Hank) Greenberg (*see* Am. Int'l Group, Inc. v. Greenberg, 965 A.2d 763 (Del. Ch. 2009)). Firm culture can be very difficult to change, especially when the new lawyer-CEO was hand-picked by his or her predecessor. For example, Citigroup's lawyer-CEO Charles Prince was handpicked by former Citigroup CEO and Prince's client Sandy Weill. *See* Loren Steffy, *Citi Settlement Doesn't Mean Lesson Learned*, HOUSTON CHRON., May 16, 2004.
[233] Michael E. Porter & Victor E. Millar, *How Information Gives You Competitive Advantage*, *in* PORTER (1996), *supra* note 7.
[234] Linda M. Applegate & Joyce J. Elam, *New Information Systems Leaders: A Changing Role in a Changing World*, 16(4) MIS QUARTERLY 469 (1992).

Research by Applegate and Elam[235] reveals that today the IT function is more closely integrated with general corporate management. IT executives are often external hires with significant experience managing a non-IT function. They are expected to gain experience in business strategy, management, and operations so they can bring a broad business perspective to the position. An increasing number of IT executives report directly to the CEO and are members of the senior management team or sit on the strategic policy committee.

Ross and Weill found that senior managers in high-performing companies take a leadership role in key IT decisions.[236] Although IT executives are the right people to make decisions about IT management, Ross and Weill recommend that the IT department should not be left to make choices (whether by default or by design) that determine the impact of IT on a company's business strategy. Indeed, Mark D. Lutchen, former Global CIO of PricewaterhouseCoopers, argues that a firm will not reap the expected benefits from technology unless the "CEO and his or her executive leadership team . . . have a conceptual understanding of how technology can support business growth."[237]

Like trustworthiness,[238] the ability to comply with the law is a valuable internal capability that can only be developed over long periods of time. Such a capability is path dependent yet also dynamic and is not a resource that can be readily bought and sold. Because it is often not clear how to develop a culture of compliance in the short to medium term, it is difficult for competitors to replicate it.

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[235] *Id.*
[236] Jeanne W. Ross & Peter Weill, *Six IT Decisions Your IT People Shouldn't Make*, 81(11) HARV. BUS. REV. 84 (2002).
[237] MARK D. LUTCHEN, MANAGING IT AS A BUSINESS: A SURVIVAL GUIDE FOR CEOS 8 (2004).
[238] Barney & Hansen, *supra* note 208.

There is a risk that including lawyers on top 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 accessing their legality may be comprised, especially when the question of legality is tinged in shades of grey as opposed to black and white."[239] Auerbach 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.[240] The risk of cooption may be particularly acute for "many lawyers [who] actively seek to join the ranks of senior management and leave the legal department altogether."[241]

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

[239] Deborah A. DeMott, *Colloquium Ethics in Corporate Representation: The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955 (2005).
[240] Joseph Auerbach, *Can Inside Counsel Wear Two Hats?,* 62(5) HARV. BUS. REV. 80 (1984).
[241] Kim, *supra* note 231, at 206.

of directors to appoint a senior lawyer who reports directly to the audit committee to act as an independent chief legal compliance auditor.

This would appear to be a significant change from current practice. Although most of the 619 participants in the 2008 Chief Legal Officer Survey conducted by the Association of Corporate Counsel indicated that the "next big issue" was "maintaining appropriate compliance programs and internal controls in the face of increasing economic concerns" and "doing more with less,"[242] there is little evidence that firms are in fact creating internal legal compliance auditing functions independent from the general counsel or chief legal officer. Thus, effective strategic compliance management may be a rare capability.

B. Nonsubstitutability

As is the case with organizational culture,[243] there are no readily apparent strategically equivalent substitutes for legal astuteness. Just as "[a] person trained as a scientist may have a difficult time understanding the point of view of a lawyer,"[244] top management teams lacking legal expertise cannot be expected to understand the legal subtleties underlying complex relationships and transactions in today's global economy.

C. Rarity

[242] *Corporate Counsel Face 'Doing More With Less,'* 17 CORP. COUNSEL WEEKLY 133 (2009).
[243] Jay B. Barney, *Organizational Culture: Can It Be a Source of Sustained Competitive Advantage?*, 11 ACAD. MGMT. REV. 656 (1986).
[244] Richard L. Daft & Robert H. Lengel, *Organizational Information Requirements, Media Richness and Structural Design*, 32 MGMT. SCI. 554, 564 (1986).

Additional empirical work is needed to determine whether legal astuteness is rare but the existing studies suggest that it is. Nelson and Nielsen found that only 25 percent of surveyed general counsel are members of the top management team.[245] Only 33 percent characterized their role as entrepreneur.[246] Unlike *cops*, who act as legal gatekeepers and render primarily legal advice to the business units, and *counsel*, who provide a mix of legal, business, and situational advice, *entrepreneurs* offer nonlegal advice on business decisions, participate in strategic planning, and market the legal function within the firm as a source of profit. According to a working paper quoted by Krasnikov, Michra and Orozco, "[M]anagers rarely work closely with the legal function of their firms."[247] Moreover, as noted earlier, many of the firms that have entrepreneurial general counsel may be incapable of effective strategic compliance management because they have not established an independent legal compliance auditing function.

As depicted in Table 6, there are degrees of legal astuteness.[248]

Table 6: Degrees of Legal Astuteness[249]

		DEGREE OF LEGAL ASTUTENESS		
		Low	→	**High**
CHARA	*Attitude of TMT Toward Legal Dimensions of Business*	Not My Responsibility		Important Part of My Job

[245] Nelson & Nielsen, *supra* note 212.
[246] *Id.*
[247] Krasnikov, Mishra, & Orozco, *supra* note 136, at 164.
[248] Bagley, *supra* note 3.
[249] *Id.* at 384.

TMT View of Lawyers	Necessary Evil		Partner in Value Creation and Risk Management
Role of General Counsel (GC)	Cop	Counsel	Entrepreneur
Frequency of GC Contact w/CEO	Low		High
Flow of Business Information and Legal Queries	On a Discrete Issue-by-Issue Basis		Ongoing
GC Is Member of TMT	No		Yes
TMT Approach to Legal Issues	Reactive		Proactive
Involvement of TMT in Managing Legal Aspects of Business	Hands Off		Hands On
TMT Approach to Regulation	Do Minimum to Comply		Exceed Regulatory Requirements as Result of Operational Changes that Increase Realizable Value
Involvement of Lawyers in Strategy Formation	Low		High
Involvement of Managers in Resolving Business Disputes	Low		High
Involvement of Managers in Contract Negotiation	Low		High
Involvement of Lawyers in Striking Deals	Low		High
Legal Literacy of Managers	Low		High
Business Acumen of Lawyers	Low		High

Again, empirical work is needed to determine how common low, medium and high degrees of legal astuteness are. "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 who do not."[250]

VI. CONCLUSION

Legal scholars need to join forces with researchers in the fields of strategy, management, and political science to understand more fully the interface of law, management, and strategy and the role of legal astuteness in the achievement and sustainability of competitive advantage. Law is more than a force that constrains managers and their firms. Properly harnessed by a legally astute management team, law can be a source of sustained competitive advantage.

[250] *Id.* at 383.