Winning Legally: The Value of Legal Astuteness

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9 April 2006
Abstract

This paper explores the value of actively managing the legal dimensions of business. It draws on the dynamic capabilities approach and postulates that “legal astuteness” — defined here as the ability of a management team to communicate effectively with counsel and to work together to solve complex problems and to protect and leverage firm resources — is a valuable dynamic capability. This paper posits that law and the tools it offers are an enabling force legally astute management teams can use to manage the firm more effectively. In particular, it proposes that legally astute management teams can, inter alia, use formal contracts as complements to relational governance to define and strengthen relationships and reduce transaction costs, enhance the realizable value of knowledge assets and certain other resources, and convert regulatory constraints into opportunities. Although empirical work is needed to determine whether and under what circumstances legal astuteness can be a source of sustained competitive advantage, there is anecdotal evidence to suggest that failure to integrate law into the development of strategy and of action plans can place a firm at a competitive disadvantage and imperil its economic viability.
In their introduction to the *Academy of Management Review*’s special topic forum “Do Governments Matter,” Ring, Bigley, D’Aunno and Khanna (2005) lament the persistent neglect of governments as contexts in organizational behavior (OB) research. This paper explores the value of actively managing the legal dimensions of business. It offers theoretical support for the assertion in Bagley (2000) that managers can use law to create value and proposes a model for understanding the value of actively managing the legal dimensions of business. In particular, this paper draws on the dynamic capabilities approach (Teece, Pisano, & Shuen, 1997) and postulates that “legal astuteness”—which I define as the ability of a management team to communicate effectively with counsel and to work together to solve complex problems and to protect and leverage firm resources—is a valuable dynamic capability. Legally astute management teams have the ability to identify and pursue opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm.

The dynamic capabilities approach asserts that the winners in today’s “Schumpeterian world of innovation-based competition, price/performance rivalry, increasing returns, and the ‘creative destruction’ of existing competencies” (Teece, Pisano and Shuen, 1997: 509) have been the firms that “can demonstrate timely responsiveness and rapid and flexible product innovation, coupled with the management capability to effectively coordinate and redeploy internal and external competencies” (1997: 515). Management of these strategic knowledge assets determines the company’s ability to survive, adapt, and to compete (Leonard, 1998) and has significant legal dimensions that remain largely unexplored in the relevant literatures.

The paper begins by outlining the four components of legal astuteness: (1) a set of attitudes, (2) a proactive approach, (3) the ability to exercise informed judgment, and (4) context-specific knowledge of the law and the appropriate use of legal tools. It then posits that legal astuteness is a managerial and organizational process that can increase realizable value in at least three ways. First, it proposes that legally astute management teams can use formal contracting and relational governance as complements to define and strengthen relationships and reduce transaction costs. Second, it discusses the ability of a legally astute management team to enhance the realizable value of knowledge assets and certain other resources. Third, it explains how legally astute managers who go beyond compliance with the letter of the law can both avoid more onerous government regulation and convert regulatory constraints into opportunities for value creation and capture. It also points out that failure to integrate law into the development of strategy and of action plans can place a firm at a competitive disadvantage and imperil its economic viability. The paper concludes by discussing areas for future
theoretical work and empirical research to determine whether and under what circumstances legal astuteness can be a source of sustained competitive advantage under the resource-based view of the firm (Barney, 1991).

In this paper I focus on the U.S. legal regime and use the term “law” to include the U.S. and state constitutions, statutes enacted by the Congress and state legislatures, regulations promulgated by federal and state regulatory agencies and their associated enforcement policies, and common law established by the courts in the course of deciding specific cases.¹ This includes the law of contracts whereby private parties can enter into binding agreements that will be enforced by the power of the state.

Many of the arguments in this paper would apply to managers in firms based outside of the United States. First, the types of issues raised in the paper are issues that every legal system will address. These include an employer’s responsibility for wrongs committed by employees and a firm’s disclosure obligations. Second, many of the legal tools addressed in the paper, such as contracts and intellectual property protection, are available (albeit to varying degrees) throughout the world. Third, many managers based outside of the United States will work for companies that either (1) have operations in the United States or (2) import products from, or export products to, the United States. Because the United States applies its laws extraterritorially to conduct occurring outside of the United States that has substantial effects in the United States, even managers based outside of the United States can find themselves sued or prosecuted under U.S. law. For example, two Japanese firms were criminally prosecuted in the United States for fixing prices for thermal fax paper that was ultimately sold by a distributor in the United States even though they reached their agreement to fix prices while in Japan (United States v. Nippon Paper Industries Co., 1998). Finally, U.S. law has influenced other countries in areas such as environmental, product liability, and insider trading laws.

ATTAINING LEGAL ASTUTENESS

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

¹ Like Hurst (1971) I do not find it useful to distinguish law from government and use “law” to refer to both.
The Attitudinal Component

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

At the same time, legally astute managers do not purport to advise themselves on legal matters of importance. They appreciate the importance of selecting a true counselor at law who combines knowledge of the black-letter law with judgment and wisdom. As Yale Law School Dean Anthony T. Kronman explained, wisdom is more than technical skill. It is the capacity to offer deliberative advice, that is, to go beyond merely supplying whatever means are needed to achieve the client’s goals and to deliberate with the client about the wisdom of the client’s ends (Kronman, 1995: 132-133). It requires character, as well as information and intelligence, to resolve the moral dilemma resulting from the divided allegiances inherent in our legal system: Lawyers are expected to be “partisan champions of their clients’ interest” but also to be “impartial officers of the court, duty-bound to uphold the law’s integrity” (1995: 144). Resisting the temptation to resolve the dilemma by always putting the client’s well-being before the law’s requires courage and civic-mindedness (1995: 145). According to Ben Heineman, General Electric’s senior vice-president, law and public affairs, “Nowadays every firm should have its own in-house lawyer-statesman” who supplies practical wisdom and not just technical mastery, understands long-term effects, and evinces a deep concern for the public interest as well as for the private good of the firm. (Economist, 2004). Or as Elihu Root put it: “About half the practice of a decent lawyer consists in telling would-be clients that they are damned fools and should stop” (Linowitz & Mayer, 1994: 4).

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

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

*The Proactive Component*

Rather than viewing the law purely as a constraint, something to comply with and react to, legally astute management teams take an active role in managing the legal dimensions of business. Instead of viewing legal considerations as an after-thought or add-on to the firm’s business strategy, legally astute managers include legal constraints and opportunities at each stage of strategy formulation and execution. Because decisions made in the early stages can dramatically affect the courses of action available in the later stages, they bring counsel in early in the cycle of decision-making. They do not wait until the last minute to fight a fire that has already started or to bless a deal that has already been struck.

Rather than seeking merely technical legal advice, legally astute managers call on their lawyers to refer to moral, economic, social, and political factors when giving advice. They demand legal advice that is business oriented, and they expect their lawyers to help them address business opportunities and threats in ways that are legally permissible, effective, and efficient. Legally astute managers work with counsel to comply with the law and take a proactive approach to regulation, both to avoid more onerous government regulation and to take advantage of the innovation opportunities regulation and deregulation offer.

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

In the absence of legal astuteness, the counsel-manager communication often takes the form of reaction-counteraction. Despite their limited legal expertise, managers are often reluctant to ask their attorneys too broad a question for fear that they might receive an answer that would preclude them from doing what they really want to do. So, the client instead frames a very technical question to the attorney, to which the attorney frames an equally technical answer, again without regard to why
the question is being asked or the broader business context within which it is being raised (Linowitz & Mayer, 1994).

This approach is depicted in Figure 1.

Figure 1

Consider the board of directors of Enron, who asked Enron’s long-time outside counsel Vinson & Elkins whether the board needed to take any action in response to an employee memo claiming accounting irregularities. The board expressly told Vinson & Elkins not to “second guess” Andersen’s accounting treatment (Oppel & Eichenwald, 2002). Vinson & Elkins duly responded to this very narrow inquiry with a reply that acknowledged that the accounting treatment was “creative and aggressive” and that there was a “serious risk of adverse publicity and litigation” due to the “bad cosmetics” of certain transactions, but concluded that no further investigation was needed (Oppel & Eichewald, 2002). The special committee of the board appointed to investigate the accounting debacle at Enron faulted Vinson & Elkins for its failure to look at the whole picture and to advise the board to probe deeper into the alleged accounting irregularities.

As discussed further below, to achieve legal astuteness, lawyers and managers must be able to understand what the other is concerned about. They need to develop a common language (Ashforth & Mael, 1992). This makes it necessary for managers to learn about the law that affects their business and for their lawyers to learn about the business so they can participate actively in each stage of strategy
formulation and execution. In the same way that the business-related capabilities of human resource professionals appear to be important contributors to strategic human resource management activities (Huselid, Jackson & Schuler, 1997), one would expect the business-related capabilities of the firm’s lawyers to be positively associated with the management of the legal dimensions of business.

The legally astute approach to the management of the legal dimensions of business is depicted in Figure 2.

**Figure 2**

Bringing together individuals, such as lawyers and managers, from “different ‘thought-worlds” may increase access to historical perspectives and multiple functional areas (Ancona & Caldwell, 1992: 323), enhance problem solving by widening scanning activities (Keck, 1997), and reduce group-think by prompting greater disagreement (Miller, Burke & Glick, 1998) but at the cost of increasing team conflict and head butting as different people use their own specialized languages, images, and stories (Miller, Burke & Glick, 1998). It may also decrease interpersonal communication and reduce perceived effectiveness (Keck, 1997). To bridge this kind of professional gap (Senge, 1990), managers and counsel must learn how to make explicit the key assumptions underlying their reasoning and engage in meaningful face-to-face interactions with others to address complex and conflicting issues. The effective management of the legal dimensions of business is based on socially
complex relations between lawyers and the other nonlawyer managers in a firm. As a result, it is not subject to low-cost imitation.

**The Judgment Component**

Law is not an exact science. Legal rules are not applied formulaically. Seemingly minor changes in facts can result in dramatically different legal outcomes. Often, there is no clear precedent to serve as a guide. Even when a company can afford to hire the best and brightest lawyers, the fact is that even the smartest lawyers get it wrong sometimes.

Managers cannot be expected to know all of the legal implications of their actions, but they do need to know when and how to obtain good legal advice. They also need to know how to factor legal considerations into business decisions and to deal with legal ambiguity and uncertainty.

Legally astute managers have the ability to exercise informed judgment when managing the legal dimensions of business. To do so effectively, managers must understand the legal ramifications of their actions and be able to factor legal risks into business decisions the same way that other risks, such as currency fluctuations or a shortage of raw materials, are factored into the risk/reward calculation.

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

For example, litigators are often overly optimistic about their chances of winning. The lawyers representing Texaco in the 1984 case brought by Pennzoil for tortious interference with its contract to acquire Getty Oil were so sure that Pennzoil’s claims had no merit that they persuaded Texaco’s board that Texaco should not even dignify the claims by putting on a damages expert (Bagley, 2005). Provided with only the assertion by Pennzoil’s expert’s that Pennzoil lost $7.5 billion when Texaco acquired Getty instead, the jury awarded Pennzoil $7.5 billion in
compensatory damages. Had Texaco’s expert testified, he would have explained that at most Pennzoil lost $500 million, the difference between the price Texaco paid for Getty in an arm’s length transaction and the price Pennzoil had agreed to pay. James W. Kinnear, who was vice-chair of Texaco during its fight with Pennzoil, came away from the experience convinced that no CEO should ever put the firm’s very survival at risk by resting its fate in the hands of a jury even when the lawyers insist that the other side has no chance of winning (Bagley, 2005). Charles Prince III, former general counsel of Travelers Insurance and current CEO of Citigroup, declared victory when he was able to settle claims of securities fraud arising out of Citigroup’s work for WorldCom for a mere $2.53 billion and thereby avoid what he dubbed a “$50 billion roll of the dice” (O’Brien, 2004).

Legally astute managers understand that every legal dispute is a business problem requiring a business solution (Bagley, 2000). Often, litigation results in a zero-sum game, with a clear winner and loser. There are fewer opportunities for integrative bargaining (Raiffa, 1992) once a dispute goes to litigation. Legally astute managers take responsibility for managing their disputes and do not hand them off to their lawyers with a “you take care of it” approach (Bagley, 2000).

Of course, general managers must also keep legal costs under control. Few start-ups have in-house counsel, and most managers cannot afford to consult outside counsel on every decision. Part of a general manager’s job is integrating all manner of perspectives, from financial experts, HR professionals, and marketing managers to lawyers. General managers must decide how much to spend to obtain more information, whether it is market research or a legal opinion. The decision of whether to hire outside counsel and to circumscribe their work will vary depending on where the decision lies on the spectrum of bright-line to fuzzy legal issue, big deal or little, current cost versus the future pay off, and current pay off versus future consequences.

The Knowledge Component

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

The more central legal considerations are to the firm’s value proposition, the greater the need for legal astuteness. In certain environments, where the firm faces legal uncertainties and contingencies that affect resources critical to the firm’s survival, boards may select lawyers to serve as chief executive officers (Pfeffer &
Salancik, 2003). Lest they have fools for clients, lawyer-CEOs should not advise themselves on legal issues of importance. The landmark case of Smith v. Van Gorkom (1985), in which the lawyer-CEO never reviewed the acquisition agreement and wrongly concluded there was no need to reserve the right to accept a better deal, is a prime example of the danger of advising oneself about legal matters of great importance.

**Legal Literacy**

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

Consider Arthur Andersen’s conviction for obstruction of justice after shredding boxes of documents relating to its audit of Enron Corporation (Oppel & Eichewald, 2002). The shredding began right after one of Arthur Andersen’s attorneys, Nancy Temple, sent an e-mail to the Andersen employees working on the Enron audit admonishing them to comply with Andersen’s document retention policy. At trial, the Andersen partner in charge of the Enron account testified that he interpreted the e-mail as a call to start shredding documents. Temple claimed that her e-mail was misconstrued, that she was not recommending the shredding of documents.

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 (Schwiegh, 1998: 54-58). By merely parroting back to the Houston employees the fact that Andersen had such a policy, Temple failed to alert the Houston employees to the fact that it is illegal to destroy documents in the face of an existing or imminent governmental investigation or lawsuit.

Managers who understand terms such as “fiduciary,” “respondeat superior,” and “contract” have a new way of talking about people and their relationships, a new “way of organizing future experience” (White, 1973: 215-216). Because “language determines what we see” (Thompson, 1978: 5), managers who can harness the creative power of legal language are more adept at seeing the legal structure of their world. They are also better equipped to communicate with their lawyers.
The top management team of a firm doing business in multiple jurisdictions might focus especially on the law of those countries where the firm has assets, operations, or important customers or suppliers. Because international law is often undeveloped, it is often not clear which country has the right to have its laws enforced. For example, U.S. law might prohibit trade with Cuba while French law permits it. The top management team of a multinational deciding whether to authorize its French subsidiary to sell goods in Cuba will have to decide whether the benefits of such a sale outweigh the risk of adverse action by the U.S. government. Understanding how the U.S. government has handled similar cases in the past will be critical to making an informed judgment.

**Legal Tools**

The legal tools of greatest relevance to managers will vary with both the firm’s overall strategy and with the stage of development of the business. Certain tools, such as contracts, have broad application. Although managers sometimes view the negotiation and drafting of contracts as a burden, contracts are powerful tools that managers can use to strengthen business relationships, discourage opportunistic behavior, allocate risk and reward, and preserve options.

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

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2 These stages are derived from those set forth in Stevenson, Roberts, & Grousbeck (1985: 17-21).
### Table A: Legal Tools for Increasing Realizable Value While Managing Risk

#### Stages of Business Development

<table>
<thead>
<tr>
<th>Create and Capture Value</th>
<th>Evaluating Opportunity and Defining Value Proposition</th>
<th>Assembling Team</th>
<th>Raising Capital</th>
<th>Development, Production, Marketing and Sale of Product or Service</th>
<th>Harvest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determination of whether idea is patentable or otherwise protectable.</td>
<td>Selection of appropriate form of business entity. Structuring appropriate equity incentives for employees. Entering into nondisclosure agreements and assignments of inventions. Securing intellectual property protection.</td>
<td>Negotiation of downside and sideways protection and upside rights for preferred stock. Imposition of vesting requirement for at least some founder stock. Determination of whether it is possible to sell stock in an exempt transaction or registration is required.</td>
<td>Implementation of trade-secret policy. Consideration of patent protection for new business processes and other inventions. Selection of a strong trademark and plan to protect it. Registration of copyrights. Entering into licensing agreements. Creation of options to buy and sell. Securing distribution rights. Consideration of whether to buy or build, then negotiation of appropriate contracts.</td>
<td>Determination of whether employee vesting accelerates on an initial public offering or sale. Assessment of ability and desirability of exercising investor demand registration rights or board control to force initial public offering or sale of company. Consideration of exemptions for sale of restricted stock. Negotiation and documentation of arrangements with underwriter or investment banker.</td>
<td></td>
</tr>
<tr>
<td>Manage Risk</td>
<td>Determination of whether anyone else has rights to opportunity.</td>
<td>Documentation of founder arrangements. Analysis of any covenants not to compete or trade secret issues. Arbitration or mediation of disputes. Compliance with anti-discrimination laws in hiring and firing. Implementation of harassment policy. Documentation of employee performance issues. Education of employees concerning discoverability of e-mail. Establishment of appropriate mechanisms to protect whistleblowers.</td>
<td>Inclusion of representations and warranties in stock purchase agreement with or without knowledge qualifiers. Choice of business entity with limited liability. Techniques to ensure respect of corporate form to avoid piercing of corporate veil.</td>
<td>Negotiation of purchase and sale contracts. Limitations on liability and releases. Securing insurance for product liabilities. Recalling unsafe products. Ensuring safe workplace. Implementation of compliance system. Due diligence before buying or leasing property to avoid environmental problems. Integration of products to avoid illegal tying. Ban on horizontal price fixing. Finding business solutions to legal disputes. Avoiding misleading advertising. Tax planning, filing of tax returns on time, and payment of taxes when due.</td>
<td>Consideration of difference between letter of intent and contract of sale. Negotiation by buyer of no-shop agreement to preclude seller from soliciting other bidders. Negotiation by seller of fiduciary out to preserve right to accept a better offer in exchange for a break-up fee. Full disclosure in prospectus or acquisition agreement. Securing indemnity rights. Due diligence procedures. Allocation of risk of unknown or uncertain through contract. Taking appropriate steps to ensure board of directors is informed and disinterested and entitled to protection of business judgment rule. Enactment of policies banning insider trading and policing trades by insiders.</td>
</tr>
</tbody>
</table>

Source: Adapted from Bagley (2005: 16-17).
LEGAL ASTUTENESS IS A VALUABLE CAPABILITY

The dynamic capabilities approach asserts that the winners in today’s “Schumpeterian world of innovation-based competition, price/performance rivalry, increasing returns, and the ‘creative destruction’ of existing competencies” (Teece, Pisano and Shuen, 1997: 509) have been the firms that “can demonstrate timely responsiveness and rapid and flexible product innovation, coupled with the management capability to effectively coordinate and redeploy internal and external competencies” (1997: 515). This paper posits that legal astuteness is a valuable dynamic capability that may, in certain contexts, be a source of sustainable competitive advantage under the resource-based view of the firm (Barney, 1991).

To the extent that management scholars have explicitly addressed the legal aspects of business, they have tended to focus on the regulatory and legitimizing aspects of law (DiMaggio & Powell, 1983; Suchman, 1995). A substantial body of literature addresses the political (Hillman & Hitt, 1999) and other “nonmarket strategies” (Baron, 1995) firms pursue to help shape the legal environment within which they do business (see, for example, Yoffie and Bergenstein, 1985; Keim & Zeithaml, 1986; Yoffie, 1987; Hillman & Hitt, 1999; Aggarwal, 2001; Shell, 2004; Bonardi, Himman, & Keim, 2005).

Legal institutions do more than regulate and constrain, however (Edelman & Suchman, 1997; Samuels, 1989). Laws liberate individual action (Commons, 1970) and facilitate various interorganizational interactions (Pearce, 2001). The law offers a toolkit that organizations can employ to construct various legal devices, such as employment contracts, proprietary information agreements, stock options, and technology licenses (Suchman, Steward & Westfall, 2001). Governments can spur or slow innovation (Spencer, Murtha & Lenway, 2005).

Hinthorne (1996: 251) presented three examples from the airlines industry to support his assertion that “lawyers and corporate leaders who understand the law and the structures of power in the U.S.A. have a unique capacity to protect and enhance share-owners wealth” (emphasis in original): (1) American Airlines successful defense against predatory pricing claims by Continental Airlines and Northwest Airlines in 1993; (2) Continental Airlines CEO Frank Lorenzo’s decision in 1983 to file bankruptcy to annul its union contracts and force its workers to accept a substantial cut in wages and benefits; and (3) the ultimately unsuccessful attempt in 1992 by officials of American Airlines, Delta Air Lines and United Airlines to persuade Transportation Secretary Andrew Card Jr. to withdraw flying certification rights from airlines that had filed for Chapter 11 bankruptcy (namely, Continental Airlines, Trans World Airlines, American West
Airlines, and Metro Airlines). Other examples are provided in Siedel (2002) and Shell (2004).

Legally astute management teams have the capability to increase and protect realizable value in at least three ways. First, they can use formal contracts as complements to relational governance to define and strengthen relationships and reduce transaction costs. Second, they can enhance the realizable value of knowledge assets and certain other resources. Third, they can convert regulatory constraints into opportunities.

Defining and Strengthening Business Relationships and Reducing Transaction Costs

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

Contract law (a sine qua non for modern economies, according to North and Weingast (1989)) makes it possible for market players to agree on their own private rules. Under the dynamic capabilities approach, a firm’s position includes its enforceable rights and contracts with suppliers and complementors (Teece, Pisano & Shuen, 1998). Courts will enforce this “manager-made law” as long as it does not conflict with fundamental public policies embodied in the public rules (Bagley, 2002).

The transaction cost economics (TCE) literature (e.g., Williamson, 1985, 1996) is the main exception to the tendency of management scholars to see law as an external force constraining managers. Firms use contracts to protect against exchange hazards, such as opportunism and reneging, which are often associated with uncertainty, specialized asset investments, and difficult performance measurement (Williamson, 1985, 1996).

Long-term contracts can buffer a seller from the instability that can result from dependence on a single critical buyer (Pfeffer & Salancik, 2003). Gilson (1984) argues that business lawyers create value by acting as “transaction cost engineers.” He cites the use of an earnout arrangement in the sale of a business as a valuable technique for addressing information asymmetry, risk, and uncertainty.
Barney and Hansen (1994) posit that managers who are highly skilled in managing contractual forms of governance, such as complete contingent claims contracts that specify the economic costs that will be imposed on parties engaging in opportunistic behavior, will have a competitive advantage over those who must use more costly 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.

A firm might merge with another or enter into a joint venture to stabilize exchange relationships, especially when operating in a highly interconnected environment (Pfeffer & Salancik, 2003). A clear contractual right to terminate a joint venture can be a valuable option to abandon under real option theory. An option to buy stock can be a valuable option to defer. Certain options, such as the option to buy or lease real property, require written contracts to be enforceable. Others can be agreed to orally but often firms put them in writing to avoid later disputes about what was agreed to. As Judge Easterbrook explained: “Memory plays tricks. Acting in the best of faith, people may ‘remember’ things that never occurred but now serve their interests. Or they may remember events with a change of emphasis or nuance that makes a substantial difference to meaning. . . . Prudent people protect themselves against the limitations of memory (and the temptation to shade the truth) by limiting their dealings to those memorialized in writing” (Rissman, 2000).

The antitrust laws make certain contracts, such as horizontal price-fixing agreements, illegal and unenforceable. There is a risk that the signaling Porter (1996) proposes firms utilize to voice displeasure with competitors can lead to price-fixing, market diversion, or other illegal collusive arrangements (Fried & Oviatt, 1989).

Parties may go to court to enforce their contractual rights, set up private dispute resolution mechanisms, or bargain informally to resolve failures of performance. Because the alternative to private dispute resolution is often the courts, bargaining typically takes place “in the shadow of the law” (Cooter, Marks & Mnookin, 1982). Thus, although it may be true that managers do not take most of their contractual disputes to court (Macauly, 1963), the law of contracts serves “as a back-up system seldom used actively, but always used passively” (Macneil, 1980: 94) to promote cooperation and the continuation of interdependence. In short, parties enter into formal contracts not because they expect to sue to enforce them but because the presence of an enforcement mechanism makes it less likely that the other party will renege.
Some scholars have argued that transaction cost economics overstates the desirability of either integration or explicit contractual safeguards to prevent reneging and opportunism (Poppo & Zenger, 2002: 707). They argue that social norms, such as trust and agreed-upon processes embedded in social relationships, operate as self-enforcing safeguards that are more effective and less costly than either explicit contracts or vertical integration (Hill, 1990; Dyer, 1997; Uzzi 1997; Dyer & Singh, 1998). Indeed, certain scholars argue that formal contracts may actually undermine a firm’s ability to develop relational governance by signaling distrust of the other party, thereby encouraging opportunistic behavior (Macauly, 1963; Ghoshal & Moran, 1996).

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

Their research revealed that relational governance and contract customization both directly and indirectly increased exchange performance as measured by satisfaction with the cost, quality, cost, and responsiveness of the outsourced service (Poppo & Zenger, 2002). This is consistent with one lawyer’s statement that he was “sick of being told, ‘we can trust old Max’ when the problem is not one of honesty but one of reaching an agreement that both sides understand” (quoted in Macaulay, 1963: 58-59). 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 Klein and Leffler (1981) and the assertion by North and Weingast (1989) that repeat play and reputation alone are insufficient to police reneging, making more complex institutional arrangements necessary. North and Weingast posit that “these institutions do not substitute for reputation-building and associated punishment strategies, but complement them” (North & Weingast, 1989: 808).

The process of negotiating a formal contract can help the parties get to know each other better, clarify their objectives and expectations, and thereby strengthen their relationship. Or it can be an adversarial, zero-sum process that
encourages each side to include, and often memorialize in obscure language, complex terms to extract rents from the other party. To achieve the complementarity between relational governance and contract customization that Poppo and Zenger (2002) found, it is important to ensure that the process of contracting does not create mistrust, generate ill will, or otherwise undermine the social norms against opportunistic behavior and reneging. It is true, however, that there may be certain settings, such as the New York diamond industry (Macauly, 1963), in which a request for a formal contract is so atypical as to be tantamount to a renunciation of the preexisting relationship.

Rather than viewing contract negotiations as a battle with a winner and a loser, legally astute management teams have the capacity to follow the recommendation of Bifani (2003: 25) that attorneys replace the “zero-sum game of adding language that is felt to be in their client’s interest and deleting contrary language” with “a careful analysis of the client’s business objectives [to determine] precisely what rights are necessary to protect these objectives. . . .”

They would also be more attuned to any indications that the relationship is faltering. Rather than delegating the resolution of disputes to the lawyers, legally astute management teams would appear more likely to view every dispute as a business problem requiring a business solution (Bagley, 2000). The solution may involve litigation, in which case legally astute managers are more likely to be actively involved to try to settle the case and to ensure that the firm’s litigation strategy is consistent with its business strategy.

Enhancing the Realizable Value of Knowledge Assets and other Resources

The sources of firm value and future growth opportunities are many and varied (Kester, 1984). It is, however, increasingly difficult to identify significant sources of firm value wherein legal rights are not important factors in realizing that value. Just as management’s ability to develop and utilize information technology applications to enhance and support other business functions may be a source of sustained competitive advantage (Mata, Fuerst, and Barney, 1995), so might management’s ability to use the law effectively to protect, realize, and leverage the value of other firm resources.

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. These include copyrighting works; patenting inventions and processes to erect barriers
to entry, reduce costs, and generate revenues; and protecting tacit knowledge and other proprietary information as trade secrets.

Microsoft’s ability to maintain its margins in excess of 90 percent is directly related to its ability to use copyright law to prevent the unauthorized copying of its products. IBM earned $1.5 billion in licensing fees and patent royalties in 2001 (Gerstner, 2002). Licensing provided IBM a way to capture the value of the discoveries that IBM did not have the ability to commercialize. It also distributed IBM’s technology more broadly and increased its ability to influence the development of industry standards and protocols (Gerstner, 2002). IBM then went a step further and began selling technology components to other companies in hopes of positioning IBM to benefit from the growth of businesses outside the computer industry that will rely on components to power new networked digital devices (Gerstner, 2002).

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

Intellectual property rights can be used both offensively to shut down a competing line of business, as happened when Polaroid used its patents to shut down Kodak’s instant camera and film business (Ingrassia & Hirsch, 1990) and defensively as bargaining chips (as happened when Amgen and Chiron settled their interleukin-2 patent infringement case by giving each other cross-licenses (Bagley, 2002). Of course, no one piece of intellectual property will provide sustained competitive advantage. Firms must continuously innovate and remake themselves to fit changing market and technological conditions. Indeed, it is important for firms to ensure that their desire to protect their existing intellectual property does not blind them to what Christensen (1997) referred to as “disruptive technologies.” One must wonder whether Polaroid’s fixation on winning its instant camera and film patent case against Kodak might have
distracted it from addressing the threats and opportunities posed by digital photography.

A firm’s position includes customer lists protectible as trade secrets and other intellectual property assets (Teece, Pisano & Shuen, 1998). Properly crafted covenants not to compete can prevent knowledge workers—the individuals “who know how to allocate knowledge to productive use, just as the capitalists know how to allocate capital to productive use” (Drucker, 1993: 69)—from taking their “tools of production” to rival firms. Under the emerging doctrine of inevitable disclosure, an employer may be able to prevent a former employee from working for a competitor, even in the absence of a covenant not to compete, if the new position would result in the inevitable disclosure or use of the former employer’s trade secrets (PepsiCo, Inc., 1995).

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

Converting Regulatory Constraints into Opportunities

Failure to implement appropriate legal measures can prevent firms from fully realizing the benefits of the other resources they control. Illegal conduct can put a firm at a competitive disadvantage. Convicted firms earned significantly lower returns on assets than unconvicted firms (Baucus & Baucus, 1997). In addition to the direct costs of sanctions (such as fines and punitive damages) and the legal costs associated with litigation and appeals, illegality can divert funds from strategic investments, tarnish a firm’s image with customers and other stakeholders, raise capital costs, and reduce sales volume (Baucus & Baucus, 1997).

At the outer bounds, failure to comply with the law can threaten the very existence and continued viability of a firm. The demise of Drexel Burnham Lambert in the late 1980s as a result of insider trading and other types of securities fraud, of Barings Bank in 1995 in the wake of rogue trading by Nick Leeson, and of Enron Corporation in 2002 after massive accounting fraud are but three examples of this phenomenon.
Because a regulatory change can affect an industry’s structure, “a company must ask itself, ‘Are there any government actions on the horizon that may influence some elements of the structure of my industry? If so, what does the change do for my relative strategic position, and how can I prepare to deal with it effectively now?’” (Porter, 1980; Jaffe & Lerner, 2004).

Regulation may provide unforeseen opportunities for profits by forcing firms to innovate (Mitnick, 1980; Porter & van der Linde, 1995). 3M claimed that the production process changes necessary to reduce polluting emissions resulted in net savings of $10 million per year (Mitnick, 1993). Proactive strategies for dealing with the interface between a firm’s business and the natural environment that went beyond environmental regulatory compliance were associated with improved financial performance (Judge & Douglas, 1998; Klassen & Whybark, 1999). Firms’ ability to reduce pollution became a source of competitive advantage only after they replaced the mindset of reducing pollution to meet government end-pipe restrictions with a search for ways to use environment-friendly policies to create value (C. Nehrt, 1998; Reinhardt, 1998; Reinhardt, 2000). Similarly, a “prospector” bank that viewed the requirements of the Community Reinvestment Act (CRA) as “an ‘opportunity’ to do more than was required and a ‘responsibility’ as a leader of the community” successfully adjusted to a tougher regulatory environment and developed innovative and profitable products to appeal to theretofore underserved lower-income strata (Fox-Wolfgramm, Boal, & Hunt, 1998).

Framing is critical here. The categorization of an issue as an opportunity or a threat can affect the decision maker’s subsequent cognitions, motivations, level of risk taking, involvement, and commitment (Thomas, Clark, & Gioia, 1993; Gilbert, 2006). Rather than treating compliance with government regulations as an expense, the cost of compliance is better framed as an investment.

To illustrate, Al Bru, the head of PepsiCo’s Frito Lay unit, worked closely with PepsiCo’s lawyers to craft PepsiCo’s strategy for dealing with increasing concerns about obesity and related diseases, such as diabetes and heart disease (Bagley, 2005). Instead of viewing health concerns as a threat, PepsiCo saw an opportunity to create new products and to reformulate existing products to meet consumers’ demand for healthier snacks. PepsiCo became the first major food company to remove trans fats from its products then used the absence of trans fats as a marketing edge.
DISCUSSION AND AREAS FOR FUTURE RESEARCH

This paper posits that a legally astute management team can, *inter alia*, use contracts to define and strengthen relationships and reduce transaction costs, enhance the value of knowledge assets and certain other resources, and convert regulatory constraints into opportunities for value creation and capture. The importance of legal astuteness can be expected to vary over time as conditions in the firm’s environment changes. As Pfeffer and Salancik (2003: 46) explained, “A lawyer may be relatively unimportant until the organization is confronted with a major lawsuit that threatens its survival.” Legal astuteness may be particularly important in “Red Queen” hypercompetitive environments where competition is fluid and opponents make it impossible for any given firm to attain a static sustainable advantage (D’Aveni, 1994).

In environments in which a high degree of legal astuteness is needed, it may be necessary to form what Clark and Wheelwright (1992) call “heavyweight teams,” comprising managers and in-house lawyers. Because the functional backgrounds of the top managers and power relations are related to a firm’s strategy (Finkelstein, 1992), the inclusion of lawyers in the top management team can be expected to affect the alternatives and the strategic choices considered (Tushman & Romanelli, 1985). Including a lawyer on the top management team may enhance problem solving by widening scanning activities (Keck, 1997), but at the cost of increasing team conflict and head butting as different people use their own specialized languages, images, and stories (Miller, Burke & Glick, 1997).

To achieve “internal integration” (Clark & Wheelwright, 1992), problem solving must be tightly connected across departmental boundaries and the costs associated with functional diversity must be overcome (Ancona & Caldwell, 1992). It is clear that “simply changing the structure of teams (i.e., combining representatives of diverse function and tenure) will not improve performance. The team must find a way to garner the positive process effects of diversity and to reduce the negative direct effects” (Ancona & Caldwell, 1992: 338). Decisions in one function can then take into account the skills and concerns of the other function (Baldwin & Clark, 1992: 70–71).

There is also a risk that including lawyers on management teams will result in their being “coopted” by the nonlawyer managers and thereby lose their objectivity. When representing a client, a lawyer is required to “exercise independent professional judgment and render candid advice” (American Bar Association, 2002: 70). A lawyer is an officer of the court charged with advising clients concerning the law and the steps necessary to comply with it.
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 prudent for the board of directors to appoint a senior lawyer who reports directly to the audit committee to act as chief compliance officer.

Extrapolating from the contingency approach to strategic human resource management (SHRM) (Youndt, Snell, Dean & Lepak, 1996), I propose that the impact on firm performance of actively managing the legal aspects of business is moderated by the firm’s strategic posture. Each different strategic orientation implies a different approach to strategic compliance management and other legal astuteness practices. For example, strong intellectual property protection would appear to be more important for a firm that pursues a strategy of product differentiation than for one pursuing a low-cost strategy that does not rely upon the existence of proprietary technologies.

As is the case with SHRM (Mahoney & Pandian, 1992; Wright, Smart & McMahan, 1995; Delery & Doty, 1996; Wright & Snell, 1998), competitive advantage may be more readily obtained when a firm’s legal strategy is effectively matched with its business strategy. Consider the ability of managers to use legal tools to realize the value of knowledge assets, such as specialized human capital. The literature on strategic human resource management has identified a variety of practices to enhance the value of human resources, including employment security (Pfeffer, 1994). To illustrate, Pfeffer (1994) points out that employment security is contrary to the doctrine of at-will employment in the United States whereby the employment relationship is deemed to be at-will in the absence of a written employment contract, a civil service system for public employees, or a collective bargaining agreement. This means that an employee may be terminated by the employer at any time for any or no reason. Pfeffer cautions that the practices lawyers tend to recommend to ensure at-will status, such as avoiding references to job security or career paths, are “almost completely antithetical to what an organization would do to achieve competitive advantage though its work force” (Pfeffer, 1994: 147). Pfeffer faults firms for turning their employee relations over to the attorneys and explains that firms
have the power to offer employment security and provide internal ways of resolving disputes rather than relying on the legal system. Legally astute managers would appear to be better equipped to integrate their legal and business strategy.

Instead of hiring employees at-will and engaging in other employment practices that undermine employee security, a firm that relies on its employees for creativity and innovation may be able to achieve competitive advantage by offering employment security and providing internal ways of resolving disputes rather than relying on the legal system (Pfeffer, 1994).

Let us first consider the use of formal contracts as complements to relational governance to define and strengthen business relationships and to reduce transaction costs. Adversarial negotiations in which the lawyer seeks to win points by negotiating the toughest deal possible for the client may be appropriate for discrete transactions with clear and readily verifiable outputs. For example, if a firm is pursuing a low-cost strategy, based on just-in-time inventory management, and can obtain commodity parts from a variety of suppliers, it may be appropriate to negotiate the lowest price per unit possible and to specify and enforce stiff penalties for failure to deliver on time. But if a firm’s low-cost strategy is based on the firm’s ability to outsource its service obligations, which are uncertain and may change over time, then creating a relationship of trust may be more important than specifying tough remedies for default. Similarly, as noted earlier, in certain contexts insisting on a formal contract may be so contrary to the cultural norms as to create immediate mistrust.

Third, let us consider firms’ ability to convert regulatory constraints into opportunities for value creation and capture. Failure to comply with applicable law can impose added costs, foreclose markets, and jeopardize the franchise. The literature on the strategic advantage accruing from proactive environmental management (Judge & Douglas, 1998; Nehrt, 1998; Klassen & McLaughlin, 1996) suggests that, at least under certain circumstances, the ability to proactively go beyond the letter of the law can result in competitive advantage. Even if efforts to convert regulatory constraints into opportunities do not lead to sustainable competitive advantage in certain contexts, organizations that have adequate procedures in place to ensure compliance with law should generate greater returns than firms that have not implemented such practices.
CONCLUSION

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

More broadly, legal scholars need to join forces with researchers in the fields of organizational behavior, strategy, institutional economics, political science, and business history to understand more fully the interface of law and management and the role of legal astuteness in the achievement and sustainability of competitive advantage. As with the study of multinational enterprises (Sundram & Black, 1992), multidisciplinary and integrative theory-building and research will be necessary in order for researchers to accurately and comprehensively understand the legal dimensions of management.
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