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WINNING LEGALLY: THE VALUE OF LEGAL ASTUTENESS

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I postulate that "legal astuteness" is a valuable managerial capability that may provide a competitive advantage under the resource-based view of the firm. Law and the tools it offers are an enabling force legally astute management teams can use to manage the firm more effectively. In particular, I propose that legally astute management teams can use formal contracts as complements to relational governance to define and strengthen relationships and reduce transaction costs, protect and enhance the realizable value of resources, use legal tools to create options, and convert regulatory constraints into opportunities.

An increasing number of lawyers are serving as CEOs of U.S. publicly traded companies (France & Laville, 2004), and legal issues, from patent cases to securities fraud, continue to pervade the business press (e.g., see Orey, 2007). Yet, to date, management and legal scholars have devoted limited attention to the importance of managing the legal dimensions of business (Ring, Bigley, D'Aunno, & Khanna, 2005). My goal in this paper is to go beyond the existing literature on the legitimizing aspects of law (DiMaggio & Powell, 1983; Scott, 1987; Suchman, 1995) and the political (Bonardi, Hillman, & Keim, 2005; Hillman & Hitt, 1999) and other "nonmarket strategies" (Baron, 1995; Shell, 2004; Siedel, 2002) firms pursue to help shape the external regulatory environment within which they do business. Rather than focusing on the regulatory and constraining aspects of law, this paper addresses its enabling aspects (Edelman & Suchman, 1997) and managers' ability to use a variety of legal tools as part of their market strategy to manage the firm more effectively.

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We know that the capabilities of the top management team (TMT) are "one of the most critical resources for a successful corporate strategy" (Shanley & Peteraf, 2004: 293). I postulate that "legal astuteness"—which I define as the ability of a TMT to communicate effectively with counsel and to work together to solve complex problems—is a valuable managerial capability that enhances firms' ability to continually innovate and remake themselves to fit changing technological, market, and institutional conditions (Teece, Pisano, & Shuen, 1997).

A capability confers competitive advantage under the resource-based view of the firm only if it is valuable, inimitable, nonsubstitutable, and rare (Barney, 1991; Peteraf, 1993). The effective management of the legal dimensions of business is based on socially complex relations between counsel and the nonlawyer managers in a firm and is context specific. Like other dynamic capabilities (Eisenhardt & Martin, 2000), legal astuteness is arguably idiosyncratic to individual firms in its details and path dependent in its emergence. If so, then legal astuteness is not subject to low-cost imitation or replication. Like trustworthiness (Barney & Hansen, 1994) and a proactive environmental strategy (Aragón-Correa & Sharma, 2003), legal astuteness may confer competitive advantage on firms possessing it but not be transferable to other firms. There are no readily apparent substitutes, but its rarity is an empirical question that is unanswered to date. Conversely, I posit that failure to integrate law into the development of strategy and of action plans can place a firm at a com-

petitive disadvantage and imperil its economic viability.

I begin this paper by outlining the four components of legal astuteness: (1) a set of value-laden attitudes about the importance of law to firm success, (2) a proactive approach to regulation, (3) the ability to exercise informed judgment when managing the legal aspects of business, and (4) context-specific knowledge of the law and the appropriate use of legal tools. I then suggest that there are degrees of legal astuteness and posit that legally astute TMTs can increase realizable value by (1) using formal contracting and relational governance as complements to define and strengthen relationships and reduce transaction costs, (2) protecting and leveraging the value of firm resources, (3) using legal tools to create options, and (4) going beyond compliance with the letter of the law and converting regulatory constraints into opportunities for value creation and capture. The paper concludes by calling for future theoretical work and empirical research to determine whether and under what circumstances legal astuteness may be a source of sustained competitive advantage under the resource-based view of the firm.

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 Congress and state legislatures, regulations promulgated by federal and state regulatory agencies and their associated enforcement policies, and common law established by the courts in the course of deciding specific cases. This includes the law of contracts whereby private parties can enter into binding agreements that will be enforced by the power of the state.

Many of the arguments in this paper would apply to managers in firms based outside of the United States. First, a number of the legal tools addressed in the paper, such as contracts and intellectual property protection, are available (albeit to varying degrees) throughout the world. Second, many managers based outside the United States work for companies that either have operations in the United States or 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 within the United States, even managers based outside the United States can find themselves sued or prosecuted under U.S. law. Finally, U.S. law has influenced other countries in such areas as environmental, product liability, and insider trading laws. Nonetheless, when trying to explain managerial behavior, one must be very careful when generalizing across cultures (Geletkanycz, 1997). Especially when faced with ambiguity and complexity, managers filter information and interpret stimuli using lenses shaped by their knowledge, beliefs, assumptions (Cyert & March, 1963; March & Simon, 1958), and values (Hambrick & Mason, 1984). Because societal values vary across cultures (Hofstede, 1991), the value a particular culture puts on complying with the law or honoring promises, for example, and the local norms regarding the use of lawyers could dramatically affect a TMT's approach to legal compliance and the use of lawyers and various legal tools.

ATTAINING LEGAL ASTUTENESS

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

The Attitudinal Component

Legally astute management teams recognize the importance of law to firm success (Shell, 2004; Siedel, 2000). Law establishes the rules of the game (North, 1990) for managers striving to create value and to capture some or all of it for the firm. Law not only enforces the social consensus on moral values but also affects the development of moral expectations, and it helps determine what roles managers play, why they play them, and whether they have played them well (Nesteruk, 1999). Legally astute TMTs appreciate the importance of meeting society's expectations of appropriate behavior (Kaplan & Norton, 2004) and of treating stakeholders fairly (Jensen, 2001). As Conoco CEO Constantine S. Nicandros explained when he announced Conoco's decision to order two new tankers with double hulls in the wake of the environmental disaster caused when the *Exxon Valdez's* single hull was breached after the ship ran aground in the Prince William Sound in Alaska in 1989, "We are in business by the public's consent. We are

sincere in our concern for the air, water, and land of our planet as a matter of enlightened self-interest" (quoted in Bagley, 2002: 19). Legally astute teams embrace the rule of law and recognize the moral aspects of strategic choice.

Legally astute TMTs 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.

For example, in 2003, EMC Corp., a leading data management hardware and software manufacturer, had to decide whether to acquire all of the stock of VMware, the developer of cutting-edge virtualization software that enabled users to run different computer operating systems (such as Windows and Linux) simultaneously on a single server (Bagley, Knoop, & Lombardi, 2006). The acquisition would significantly further EMC's strategy of becoming the premier firm for the storage, manipulation, and protection of information, but it would also embroil EMC in protracted patent litigation between VMware and Microsoft Corporation. EMC's CEO Joseph Tucci worked with EMC's general counsel Paul Dacier to understand the inherently uncertain legal and business risks involved, but both Tucci and Dacier recognized that Tucci had ultimate responsibility for deciding whether to proceed with the acquisition.

Law is rarely applied in a vacuum, and its application to a given set of facts is often not clear-cut. Legally astute TMTs understand that legal inference is often highly ambiguous (Langevoort & Rasmussen, 1997) and that the regulatory environment is often "contested and riddled with loopholes" (Edelman & Suchman, 1997: 487). Although Congress and the U.S. Supreme Court have declared certain conduct to be clearly illegal, the legal analysis of most courses of action is far more subtle. There are large gray areas.

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

The Proactive Component

Rather than viewing the law purely as a constraint—something to react to and comply with—legally astute management teams include legal constraints and opportunities at each stage of strategy formulation and execution. They take a proactive approach to regulation, both to avoid more onerous government regulation and to take advantage of the innovation opportunities regulation and deregulation offer. For example, Regina Corporation reduced its product liability exposure and created a better product in the process when it equipped its home spa appliances with an immersion detection circuit interrupter that would protect users from electric shock should they accidentally drop the appliance in water (Bagley, 2005). Because decisions made in the early stages can dramatically affect the courses of action available in the later stages, legally astute management teams recognize inside counsel's "right and responsibility to insist upon early legal involvement in major transactions" (Chayes & Chayes, 1985: 281).

Legally astute management teams 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 (Daly, 1997). For example, Indra K. Nooyi, then president and chief financial officer of PepsiCo, encouraged PepsiCo's lawyers to bring both their legal expertise and business judgment to bear, saying, "We can't afford this separation of church and state" (quoted in Bagley, 2005: 227). Legally astute TMTs expect their lawyers to refer to moral, economic, social, and political factors when giving advice and to function as "counsel" and "entrepreneurs," not as "cops" (Nelson & Nielsen, 2000).

Cops are gatekeepers who are primarily concerned with policing the conduct of the business units. They are very reluctant to offer nonlegal advice. *Counsel* play a significant gatekeeper role as well, but also 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 as a source of profits. Of the forty-two inside counsel from twenty-two large corporations and financial institutions interviewed by Nelson and Nielsen, 17 percent characterized their role as cop, 50 percent as counsel, and 33 percent as entrepreneur. One-quarter were members of the TMT. Research concerning the role of inside counsel in the 1960s and 1970s revealed cops and counsel but not entrepreneurial lawyers (Nelson & Nielsen, 2000).

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

Management teams lacking the requisite degree of legal astuteness tend to view legal considerations as an afterthought or add-on to the firm's business strategy. They often treat the firm's lawyers as a "necessary evil" (Nelson & Nielsen, 2000: 474)—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).

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

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 it concluded that no further investigation was needed (Oppel & Eichenwald, 2002). The special committee of the board appointed to investigate the accounting debacle at Enron later 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.

The Judgment Component

Law is not an exact science—legal rules are not applied formulaically. Seemingly minor changes in facts can result in dramatically different legal outcomes. Often, there is no clear precedent to serve as a guide. Dealing effectively with the uncertainties inherent in many decisions having legal aspects requires the exercise of informed judgment. Legally astute managers—even those with formal legal training—do not purport to advise themselves on legal matters of importance. They appreciate the importance of selecting a true counselor at law who combines knowledge of the black-letter law with judgment and wisdom. As Yale Law School Dean Anthony T. Kronman (1995) explained, wisdom is more than technical skill; it is the capacity to offer deliberative advice—that is, to go beyond merely supplying whatever means are needed to achieve the client's goals and to deliberate with the client about the wisdom of the client's ends (Kronman, 1995: 132–133). Certain courses of action may be legal but not wise.

Part of the TMT's job is to integrate 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 market research or a legal opinion. Even when a

company can afford to hire the best and brightest lawyers, the fact is that the smartest lawyers get it wrong sometimes.

In certain instances lawyers may have economic reasons to overstate legal risk. By identifying risks that can be managed only with careful legal guidance, outside lawyers are able to justify spending more time on both legal research and transactional assistance, such as contract drafting and negotiation, and thereby to maximize their income (Langevoort & Rasmussen, 1997). An in-house lawyer may be able to justify larger budgets and perhaps higher status. In addition, both inside and outside counsel are more likely to incur a reputational (and perhaps financial) penalty if they advise a client to proceed with a transaction that is later deemed unlawful than if they either advise against proceeding or advise proceeding only with excessive and costly precaution (Langevoort & Rasmussen, 1997).

Professional norms may also prompt lawyers to err on the side of caution. Cognitive biases may come into play as well when lawyers are faced with high ambiguity (Langevoort & Rasmussen, 1997). Sometimes, the need to keep an important client happy (Kim, 2001) or overconfidence bias can cloud a lawyer's judgment. Lawyers often overestimate their ability to resist the social and cognitive pressures that can compromise their judgment (Langevoort & Rasmussen, 1997). For example, litigators are often overly optimistic about their chances of winning, even when the statistics on similar cases would suggest a lower probability of success (Kahneman & Lovallo, 1993). Legally astute TMTs take such biases into account when factoring legal advice into business decisions.

Consider the lawyers representing Texaco in the 1984 case brought by Pennzoil for tortious interference with its contract to acquire Getty Oil. Texaco's lawyers were so sure that Pennzoil's claims had no merit they persuaded the board of directors that Texaco should not even dignify the claims by having a damages expert testify (Bagley, 2005). Provided with only the assertion by Pennzoil's experts that Pennzoil lost $7.5 billion when Texaco acquired Getty instead, the jury awarded Pennzoil $7.5 billion in compensatory damages. Had Texaco's expert testified, he would have explained that, at most, Pennzoil lost $500 million—the difference between the price Texaco paid for Getty in an arm's-length transaction and the price Pennzoil had agreed to pay. James W. Kinnear, who was vice-chair of Texaco during its fight with Pennzoil, came away from the experience convinced that no CEO should ever put the firm's very survival at risk by resting its fate in the hands of a jury, even when the lawyers insist that the other side has no chance of winning (Bagley, 2005).

Legally astute TMTs understand that every legal dispute is a business problem requiring a business solution (Bagley, 2000). They take responsibility for managing their disputes and do not hand them off to their lawyers with a "you-take-care-of-it" approach. Because legally astute TMTs make strategic choices about when and how to use litigation as a competitive tool (Priest & Klein, 1984), they should achieve better outcomes.

The Knowledge Component

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

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-owner wealth" (1996: 251). For example, Continental Airlines CEO Frank Lorenzo put Continental in bankruptcy in 1983 to annul its union contracts and force its workers to accept a substantial cut in wages and benefits. Intel's success in avoiding the type of antitrust litigation that has plagued Microsoft is largely attributable to its ability to educate its managers concerning the legal limits on aggressive competition (Yoffie, 2000).

Legal literacy. Managers and lawyers use distinct mental models, which impede 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 succinctly put it, "A person trained as a scientist may have a difficult time understanding the

point of view of a lawyer" (1986: 564). The same is true of a person trained as a manager.

To achieve legal astuteness, managers must be able to understand what their lawyers are talking about. They need a common vocabulary to "typify and stabilize experiences and integrate those experiences into a meaningful whole" (Pettigrew, 1979: 575). Managers who understand such terms as *fiduciary, respondeat superior,* and *contract* have a new way of talking about their responsibilities and relationships. As Mills explained, "A vocabulary is not merely a string of words; immanent within it are societal textures—institutional and political coordinates. Back of a vocabulary lie sets of collective action" (1972: 62). Managers who can harness the creative power of legal language are more adept at seeing and shaping the legal structure of their world. They are also better equipped to communicate effectively with their lawyers.

Legal tools. The law offers a variety of tools legally astute management teams can use to increase realizable value and to manage risks (Bagley, 2005). The legal tools of greatest relevance to managers will vary with the firm's overall strategy, its external environment, and the stage of development of the business. Certain tools, such as contracts, have broad application.

For example, the choice of business entity (e.g., corporation, partnership, or limited liability company) will determine the investors' liability for the debts of the business, the rights and responsibilities of the managers and equity holders, and the level at which tax is levied. TMTs who can incorporate tax planning techniques into their overall business strategy have an enhanced ability to generate after-tax income (Scholes & Wolfson, 1992).

DEGREES OF LEGAL ASTUTENESS

To be legally astute, a TMT must have the value-laden attitudes, proactive approach, ability to exercise informed judgment, and context-specific knowledge described above. There are degrees of legal astuteness, however. For example, a TMT can be legally astute even if the general counsel is not a member of the TMT, but TMTs that include the general counsel have a higher degree of legal astuteness than those that do not. The more central legal considerations are to the marshaling and deployment of resources critical to the firm's survival (Pfeffer & Salancik, 2003), the greater the need for legal astuteness. Table 1 summarizes the key characteristics associated with low and high degrees of legal astuteness.

Extrapolating from the contingency approach to SHRM (Youndt, Snell, Dean, & Lepatz, 1996), I would expect the impact of actively managing the legal aspects of business on firm performance to be moderated by the firm's strategic posture and its external environment. Firms that attain a degree of legal astuteness that "fits" with their strategic posture and their external environment should realize greater value from this managerial capability than those that do not.

LEGAL ASTUTENESS IS A VALUABLE CAPABILITY

Legally astute management teams have the ability to identify and pursue opportunities to use the law and the legal system to increase both the total value created and the share of that value captured by the firm in at least four ways. They can (1) use formal contracts as complements to relational governance to define and strengthen relationships and reduce transaction costs, (2) protect and enhance the realizable value of firm resources, (3) use contracts and other legal tools to create options, and (4) convert regulatory constraints into opportunities.

Defining and Strengthening Business Relationships and Reducing Transaction Costs

Firms use formal 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). Although in certain settings repeat play, trust building, open communication, flexibility, and other relational governance techniques may be sufficient to ensure exchange performance (Ghoshal & Moran, 1996; Macauly, 1963), relational governance alone is often insufficient to prevent reneging, making more complex and potentially more expensive institutional arrangements necessary (Klein & Leffler, 1981; North & Weingast, 1989). Long-term contracts can buffer a seller from the instability that can result from dependence on a single critical

TABLE 1
Degrees of Legal Astuteness

Characteristics	Degree of Legal Astuteness		
	Low ——————————→		High
Attitude of TMT toward legal dimensions of business	Not my responsibility		Important part of my job
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

buyer (Pfeffer & Salancik, 2003). 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). An earnout arrangement in the sale of a business, whereby the purchase price is contingent on the postacquisition earnings of the acquired firm, can be a valuable technique for addressing information asymmetry, risk, and uncertainty (Gilson, 1984).

Contract law, a sine qua non for modern economies (North & Weingast, 1989), makes it possible for market players to agree on their own private rules. 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). Courts will enforce this "manager-made law" as long as it does not conflict with fundamental public policies embodied in the public rules. Part of legal literacy is understanding the public policy limits on private ordering.

Not all firms are equally adept at achieving the expected gains from their formal contracts (Lacity & Willcocks, 1998; Poppo & Zenger, 2002). This systemic variation among firms suggests the existence of a distinct firm-specific capability. Under the dynamic capabilities approach, a firm's position includes its enforceable rights and contracts with suppliers and complementors (Teece et al., 1997). Barney and Hansen (1994) have posited that managers who are highly skilled in managing contractual forms of governance, such as complete contingent claims contracts that specify the economic costs that will be imposed on parties engaging in opportunistic behavior, will have a competitive advantage over those who must use more costly market forces of governance (such as equity joint ventures) or hierarchical forms of governance (such as vertical integration) to protect against ex-

change vulnerabilities. This paper builds on that argument and seeks to explain some portion of that interfirm variance through the construct of legal astuteness.

Although certain scholars (e.g., Ghoshal & Moran, 1996; Macauly, 1963) have argued that formal contracts signify mistrust and thereby undermine relational governance, there is evidence that formal contracts and relational governance can be complements. Using data on outsourcing relationships in information services during the early 1990s, Poppo and Zenger (2002) found that contract customization and relational governance both directly and indirectly increased exchange performance as measured by satisfaction with the cost, quality, and responsiveness of the outsourced service. They 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 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 Macauly, 1963: 58–59).

Managers who actively participate in contract negotiations should be better able both to ensure that their lawyers understand the business implications of various negotiating positions and to prevent their lawyers' zeal to "win points" (Bifani, 2003; Ertel, 2004) from undermining the relationship with the other side. At the same time, managers who involve their lawyers in the process of crafting the deal structure and terms at the outset should achieve more favorable results than those who first reach an agreement in principle with their counterparts on the key business terms and then leave it up to the lawyers to "paper the deal."

If this reasoning is correct, we should find that legally astute management teams realize more value from their contractual relationships than teams lacking legal astuteness. More specifically, just as Lacity and Willcocks (1998) found that senior executives and IT managers who made sourcing decisions together achieved expected cost savings with a higher relative frequency than either group acting alone, I would expect that legally astute managers and lawyers who work together to craft the business deal and to negotiate the formal contractual arrangements would achieve the expected exchange performance with a higher relative frequency than management teams that first strike the business deal and then bring the lawyers in to document it.

Protecting and Enhancing the Realizable Value of Firm Resources

The sources of firm value and future growth opportunities are many and varied. It is difficult, however, 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 use IT applications to enhance and support other business functions may be a source of sustained competitive advantage (Mata, Fuerst, & Barney, 1995), so might a legally astute TMT's ability to use the law effectively to protect, realize, and leverage the value of other firm resources. I would expect legally astute TMTs to be more successful at protecting and leveraging the value of firm resources than teams lacking that capability. Conversely, 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.

Intellectual property law provides managers with various techniques to realize the value of knowledge. These include copyrighting original 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 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 also distributed IBM's technology more broadly and increased its ability to influence the development of industry standards and protocols (Gerstner, 2002). 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).

A firm's position includes customer lists protected as trade secrets and other intellectual property assets (Teece et al., 1997). Properly crafted covenants not to compete can prevent knowledge workers—the individuals "who know how to allocate knowledge to productive use, just as the capitalists know how to allocate capital to productive use" (Drucker, 1993: 8)—from taking their "tools of production" to rival firms. By keeping many of its production processes trade secrets, Lincoln Electric Company preserved their value as scarce resources (Peteraf & Barney, 2003). Under the 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. v. Redmond,* 1995).

The paths available to a firm include the increasing returns available to firms with proprietary technologies (Teece et al., 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). In contrast, Kodak's policy of not selling replacement parts was struck down as an illegal tie, in part because Kodak had changed its policy retroactively, after consumers had already purchased capital-intensive copiers with a long, useful life, and in part because Kodak's parts manager testified at trial that patents never crossed his mind when the company adopted a policy not to sell to ISOs (Bagley & Clarkson, 2003). A legally astute TMT would have ensured that the parts manager understood the permissible scope of Kodak's patent protection so he could testify truthfully about Kodak's desire to exercise its legal right to exploit the value of its patents.

Of course, no one piece of intellectual property will provide sustained competitive advantage. Firms in turbulent environments must continuously innovate and remake themselves to fit changing market and technological conditions (Teece et al., 1997). Firms that try to lock in their customers may lose them instead (Malone, Yates, & Benjamin, 1989). In addition, it is important for firms to ensure that their desire to protect their existing intellectual property does not blind them to "disruptive technologies" (Christensen, 1997).

Using Legal Tools to Create Options

Real options theory posits that there is value inherent in the right to delay a decision characterized by uncertainty (Kogut & Kulatilaka, 2001). An option, which is sometimes but not always embodied in a contract, is an investment in the right to defer a decision until additional information becomes available or until uncertainties are otherwise resolved. Certain options, such as the right to acquire real property or to renew a lease, must be evidenced by a written agreement to be enforceable.

An option to buy stock can be a valuable option to defer. A clear contractual right to terminate a joint venture can be a valuable option to abandon. Subjecting a founder's shares to vesting and hiring employees at-will enhance a venture capitalist's ability to change the management team in the future. Coinvestment rights preserve early investors' option to invest in later financing rounds. Even the decision regarding whether to pursue litigation or to settle at various stages can be viewed as the exercise of an option (Grundfest & Huang, 2006). TMTs who understand how to use such tools effectively should achieve higher levels of performance than those lacking that capability.

Converting Regulatory Constraints into Opportunities

We know that a relentless focus on performance can lead managers to make decisions that result in illegal behavior. Failure to comply with applicable law can impose added costs, foreclose markets, and jeopardize the franchise. Convicted firms earn 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 & Bau-

cus, 1997). Organizations that have adequate procedures in place to ensure compliance with the law should generate higher returns than firms that do not implement such practices.

At the outer bounds, failure to comply with the law can threaten the 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 (Stewart, 1991), and that of Enron in 2002 after massive accounting fraud (Oppel & Eichenwald, 2002), are but two examples of this phenomenon.

At least under certain circumstances, however, the ability to proactively go beyond the letter of the law can result in competitive advantage. Regulation may provide unforeseen opportunities for profits by forcing firms to innovate (Mitnick, 1980; Porter & van der Linde, 1995). For instance, proactive strategies for dealing with the interface between a firm's business and the natural environment that went beyond environmental regulatory compliance were associated with improved financial performance (Judge & Douglas, 1998; Klassen & Whybark, 1999). Yet firms' ability to reduce pollution became a source of competitive advantage only after managers replaced the mindset of reducing pollution to meet government end-pipe restrictions with a search for ways to use environment-friendly processes to create value (Nehrt, 1998). Similarly, a "prospector" bank that viewed the requirements of the Community Reinvestment Act 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: 112).

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). Legally astute management teams practice strategic compliance management (Bagley, 2005). They view the cost of complying with government regulations as an investment, not an expense. Instead of just complying with the letter of the law, they seek out and embrace operational changes that will enable them to convert regulatory constraints into innovation opportunities.

CONCLUSION

Given the financial resources and management time firms devote to legal matters, the time seems ripe for new research on how TMTs manage the legal aspects of business. In this paper I introduced the construct of legal astuteness and argued that it is a valuable managerial capability that enables firms to increase realizable value in at least four ways. I also suggested that, in certain contexts, legal astuteness may be a source of competitive advantage under the resource-based view of the firm.

Multidisciplinary and integrative theory building and empirical research will be necessary to understand more fully the interface of law and management and the role of legal astuteness in the achievement and sustainability of competitive advantage. Research questions include the following: What organizational structures are best suited for achieving the benefits of legal astuteness? For example, should the chief legal officer be a member of the TMT? If so, how do firms prevent in-house lawyers from being co-opted by nonlawyer managers (Auerbach, 1984; DeMott, 2005)? Is legal astuteness rare? Are there certain industries in which legal considerations are more important than others? Do lawyers make good CEOs? My hope is that this paper has helped lay the theoretical foundation for further work in this important area.

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