The top management team (TMT) of a firm evaluates and pursues opportunities for value creation and capture while managing the attendant risks. Value is created whenever the value of a product or service to the customer exceeds the cost of producing it. All or part of that value can be captured by the various players in the value chain, including suppliers of raw materials and other tangible resources, employees and other providers of human capital, investors and other providers of financial capital, and customers. Given the characteristics of the TMT and their personal values, the parameters set by the public law, the firm’s position within the competitive environment, and the nature and distinctiveness of the firm’s resources, the top management team defines the value proposition and selects and performs the activities in the value chain.

Compliance with law is just the baseline for managerial behavior. Legally astute managers consider not only what the firm can do but also what it should do. Accordingly, “business decisions consist of continuous, interrelated economic and moral components” and “the moral aspects of choice” are the “final component of strategy.”

In a democracy, society grants rights and powers to business, which society can revoke if firms do not act responsibly. As Tom Stephens, CEO of Manville Corporation, put it when he decided to add labels to Manville’s fiberglass products warning of possible carcinogenic risks, “The laws of society are more powerful than any law that Congress can put on the books. Woe to any businessman who doesn’t read the laws of society and understand them.” Moreover, ethical considerations often affect how the laws on the books are interpreted and applied.

Public Policies Underlying Business Regulation

Public law—the formal rules embodied in constitutions, statutes enacted by legislatures, judicial decisions rendered by courts, and regulations promulgated by administrative agencies—both reflects and helps shape social expectations. The laws and regulations applicable to U.S. business in the early twenty-first century further, or purport to further, four primary public policy objectives: promoting economic growth, protecting workers, promoting consumer welfare, and promoting public welfare. This typology is depicted in Figure 1.

Other advanced states tend to have laws that further, or purport to further, these same objectives, albeit with varying degrees of emphasis on the different objectives and varying ways of pursuing them. Indeed, much of the current debate on what constitutes good corporate governance turns on how much weight each country gives to the interests of shareholders, debtholders, employees, customers, and suppliers and to the protection of the environment.
Effect of Law on the Competitive Environment and Firm Resources

Law helps shape the competitive environment and affects each of the five forces that determine the attractiveness of an industry: buyer power, supplier power, the competitive threat posed by current rivals, the availability of substitutes, and the threat of new entrants. Table 2 offers examples of how managers can use law and public policy to affect the five forces, organized by the public policies furthered by business regulation.

Law also limits the manner in which firms can marshal and deploy physical, financial, and human resources. For example, laws regarding at-will employment, wrongful termination, and employment discrimination govern the firm’s relationships with its workers. Judicial decisions that increase the directors’ exposure to personal liability for corporate decisions affect corporations’ ability to attract and retain qualified independent directors.
FIGURE 2: Using Law and Policy to Affect the Competitive Environment

<table>
<thead>
<tr>
<th>Direct Competition</th>
<th>Threat of Entry</th>
<th>Substitution</th>
<th>Supplier Power</th>
<th>Buyer Power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promote Economic Growth</td>
<td>Obtain development subsidies, tax breaks for domestic firms; litigate to enforce antitrust laws</td>
<td>Secure patents and other IP rights; obtain protectionist tariffs to advantage domestic firms</td>
<td>Secure trademarks; protect trade secrets; enter into employment agreements with covenants not to compete; subject employee stock to vesting</td>
<td>Enter into long-term supply contracts; reduce import duties and quotas</td>
</tr>
<tr>
<td>Protect Worker Interests</td>
<td>Restrict visas needed by rivals: tighten OSHA regulations to detriment of lesser rivals</td>
<td>Penalize “foreign” outsourcing; enact antitakeover protection</td>
<td>Increase funding for education; secure restrictions on worker layoffs</td>
<td>Prohibit union abuses</td>
</tr>
<tr>
<td>Promote Consumer Welfare</td>
<td>Outlaw competing products on safety grounds</td>
<td>Impose licensing regime; demand posting of bond by service providers</td>
<td>Require labeling of “foreign” parts; outlaw substitute products on safety grounds or require extensive safety testing before approval</td>
<td>Impose mandatory licensing requirements; litigate and legislate to weaken patent protection</td>
</tr>
<tr>
<td>Promote Public Welfare</td>
<td>Obtain ethanol-style subsidies for firm’s product; limit emissions to detriment of lesser rivals; seek federal regulation that preempts more burdensome local laws</td>
<td>Limit bidding on government contracts to domestic firms</td>
<td>Lower taxes and reduce government funding on research and development to avoid deficit</td>
<td>Impose domestic content requirement to foil importers; improve transportation infrastructure</td>
</tr>
</tbody>
</table>

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. Consider the demise of investment bank Drexel Burnham in the wake of the insider trading scandals of the 1980s; the collapse of the savings and loan industry as a result of massive fraud; the implosion of Barings, England’s oldest merchant bank after illegal trades by Nick Leeson; and the disintegration of the once venerable accounting powerhouse Arthur
Andersen. In the case of WorldCom, $200 billion of shareholder value was lost in fewer than twelve months, making it the largest corporate fraud in history."

Even if the firm survives, noncompliance destroys value. Illegal conduct can put a firm at a competitive disadvantage by diverting funds from strategic investments, tarnishing a firm's image with customers and other stakeholders, raising capital costs, and reducing sales volume. "Researchers found that Fortune 500 firms convicted of legal violations earned significantly lower returns on assets than non-convicted firms. " In 2000, Cendant paid $3.19 billion to settle securities fraud cases arising out of its fraudulent financial reporting. The market capitalization of the firm had dropped $14 billion in one day after the fraud came to light. Violation of the criminal laws can also land an executive in prison, as happened to Jeffrey Skilling, former CEO of Enron, who was convicted of fraud and sentenced to more than twenty-four years in prison.

Law does more than regulate and constrain, however. It also enables and facilitates. Corporate laws granting limited liability to investors, bankruptcy laws giving fresh starts to entrepreneurs, and securities laws requiring transparency and limiting insider trading make it easier for firms to raise financial capital. Intellectual property protections, ranging from patents and copyrights to trade secrets and trademarks, help firms erect barriers to entry, differentiate their products, command premium prices, reduce costs, generate revenues, and create a culture of innovation.

Managers can make their own “private law” by entering into contracts enforced by the state and by crafting certain governance structures. Contracts can strengthen relationships, reduce transaction costs, and enhance performance.” The availability of a limited partnership as a form for organizing a venture capital fund and of convertible preferred stock, with a variety of rights, preferences and privileges, was key to the growth of the U.S. venture capital industry.

At least under certain circumstances, the ability to proactively go beyond the letter of the law can result in competitive advantage. " In fact, regulation may prompt firms to innovate, making them more competitive." Legally astute management teams practice strategic compliance management." They view the cost of complying with government regulations as an investment, not an expense. For example, a bank that viewed compliance with the Community Reinvestment Act as an “opportunity” to become a better corporate citizen was able to develop new and profitable products to appeal to theretofore underserved lower-income customers.

Instead of just complying with the letter of the law, legally astute managers seek out and embrace operational changes that will enable them to convert regulatory constraints into innovation opportunities. " For example, firms that replaced the mindset of reducing pollution to meet government end-pipe restrictions with a search for environment-friendly processes to create value achieved superior financial performance." CEO Jeff Immelt of General Electric justified his decision to launch GE’s Ecomagination "green" initiative by the prospect of “accelerating economic growth.”“ PepsiCo responded to proposed regulations by the Food and Drug Administration to require trans fat labeling by removing trans fats from its potato chips and other Frito Lay snacks, then used the absence of trans fats as a marketing edge.

Firm activities in the value chain, including lobbying, can affect not only the value and allocation of firm resources and the competitive environment but also the laws that regulate business and the ways they are interpreted and applied over time. Conduct that affects the broader society in an adverse way may also prompt changes in the public law. Laws enacted in response to corporate misdeeds, such as accounting fraud in the case of the Sarbanes-Oxley Act of 2002, improper disposal of hazardous waste in the case of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, and massive bribery in the case of the Foreign Corrupt Practices Act in 1978, often impose greater restrictions and costs on business than would have been imposed had firms acted more responsibly at the outset. The subprime mortgage crisis has already led to calls for more regulation.
Law and the Value Chain

As seen in Figure 3 below, there are legal aspects of each activity in the value chain.

For example, the Uniform Commercial Code and the Convention on the International Sale of Goods provide default rules, which the parties can modify by express contractual provisions. These include rules specifying who bears the risk of loss if goods are lost or damaged prior to delivery, and when is performance excused due to frustration of purpose or commercial impracticability. Court cases and statutes impose strict liability on firms in the chain of distribution for defective products. Liability extends to manufacturers, distributors, wholesalers, and retailers. A variety of state and federal statutes and regulations protect consumers from deceptive advertising, sales, lending, and pricing practices and from invasions of privacy.

The contract of sale as well as any express or implied warranties will determine a firm’s ongoing service obligations. Customer releases, disclaimers of implied warranties, and provisions limiting liability to replacement or repair and disclaiming liability for consequential damages can limit the seller’s exposure for property damage if a product does not meet the purchaser’s expectations.

The decision to outsource part of the value chain (such as manufacturing or service) rather than to perform those functions internally rests on the assumption that the other firm will be legally required to perform the outsourced activity at the agreed upon price. Courts will enforce such provisions as long as they do not allocate risk in an objectively unreasonable manner.

Potential legal liability also affects the boundaries of the firm. Researchers found that exposure to liability stemming from employees’ on-the-job exposure to hazardous materials made firms more likely to adopt a non-vertically integrated production system.

Developing the Managerial Capability of Legal Astuteness

At its core, legal astuteness is the ability of managers to communicate effectively with counsel and to work together to solve complex problems. Legal astuteness has four components: (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.

Value-Laden Attitudes

Legal astuteness begins with respect for the law. Legally astute management teams appreciate the importance of meeting society’s expectations of appropriate behavior and of treating all stakeholders fairly.

They accept responsibility for managing the legal dimensions of business and 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 determine whether a particular risk is worth taking or a particular opportunity is worth pursuing.

Proactive Approach

Legally astute managers include legal considerations at each stage of strategy development and implementation. They bring counsel in early and do not wait until a deal has been struck or a problem has
## FIGURE 3: Law’s Role in the Value Chain

<table>
<thead>
<tr>
<th>Support Activities</th>
<th>Firm Infrastructure</th>
<th>Human resource management</th>
<th>Technology development</th>
<th>Procurement</th>
</tr>
</thead>
</table>

### Primary Activities

<table>
<thead>
<tr>
<th>Inbound logistics</th>
<th>Operations</th>
<th>Outbound logistics</th>
<th>Marketing and sales</th>
<th>Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracts</td>
<td>Workplace safety &amp; labor relations</td>
<td>Contracts</td>
<td>Consumer protection laws, including privacy protection</td>
<td>Strict product liability</td>
</tr>
<tr>
<td>Antitrust limits on exclusive dealing contracts</td>
<td>Environmental compliance</td>
<td>Environmental compliance</td>
<td>Bans on deceptive or misleading advertising or sales practices</td>
<td>Warranties</td>
</tr>
<tr>
<td>Environmental compliance</td>
<td>Process patents and trade secrets</td>
<td>Environment</td>
<td>Antitrust limits on vertical and horizontal market division, tying, and predatory pricing</td>
<td>Waivers &amp; limitations of liability</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Compliance</td>
<td></td>
<td>Doctrine of unconscionability</td>
</tr>
</tbody>
</table>

arisen to seek legal advice. They demand legal advice that is business oriented and expect their lawyers to help them address business opportunities and threats in ways that are legally permissible, effective, and efficient.

**Exercising Informed Judgment**

Legally astute managers understand that legal analysis is often ambiguous and that managing the legal aspects of business requires the exercise of informed judgment. Even the most skilled and experienced advisors, including lawyers, get it wrong sometimes. A lawyer’s judgment can be clouded by personal interests, such as increasing billable hours or angling for more power within the firm, or by over-sensitivity to risk or over-confidence bias. Legally astute managers take this into account when factoring in legal advice.

Every legal dispute is a business problem requiring a business solution. 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.

**Contextual Knowledge of the Law and Legal Tools**

Legally astute managers have content-specific knowledge of the law and the application of legal tools. 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.

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

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Endnotes

1. Richard S. Ely Professor of Management & Professor of Political Science, Yale School of Management.
2. Visiting Associate Professor of Business Administration, Yale School of Management.


6. For example, Germany seeks to promote economic growth by facilitating the capital markets, but its goal of protecting workers has led to the system of codetermination whereby half the members of the supervisory boards of large German corporations are elected by the workers and unions, and half are elected by the shareholders.


12. Ibid.


14. Ibid.


16. Ibid., pp. 50-86.


22. This discussion is drawn from Bagley, “Winning Legally.”
