

What's Law Got to Do with It: A Systems Approach to Business and Society

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Business and Society”**

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July 7, 2008

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ABSTRACT

This paper introduces the systems approach to business and society, an integrating descriptive framework that embeds legal considerations and societal expectations in mainstream theories of competitive advantage. The systems approach rejects the bifurcation of organizational context into market and nonmarket components and offers a bridge between descriptive research on strategic competitive advantage and normative business-and-society scholarship.

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Governments immerse modern organizations “in a sea of law” (Edelman & Suchman, 1997: 480) and legitimize a variety of firm activities (DiMaggio & Powell, 1983). Although scholars have repeatedly underscored the need for research that integrates insights from law into organizational analysis (e.g., Ring, Bigley, D’Aunno, & Khanna, 2005; Shaffer, 1995; Williamson, 1991), the literatures on first mover advantage and the sustainability of competitive advantage “generally have missed the importance of the relationship between the resources of the firm and the regulatory context in which they are deployed” (Nehrt, 1998: 77). There are multiple references to “nonmarket” factors in the strategy, organization, and management literatures (Boddewyn, 2003), but there is no single model that integrates the structures of markets with the characteristics of the nonmarket environment (Baron, 2001: 47-48).

This paper seeks to fill this gap in the literature by offering the systems approach to business and society, a descriptive integrating framework (Jones, 1983: 560) that embeds legal considerations and other “nonmarket” factors, including social institutions, customs, social embeddedness, and “the extra-market and pre-market values of honor, trust, loyalty, decency, and fairness” (Kuttner, 1998: 64), in mainstream theories of competitive advantage. The systems approach marries the resource-based view of the firm (Barney, 1991; Peteraf, 1993) with the effect of the five forces on the competitive environment (Porter, 1980), the activities in the value chain (Porter, 1985), and the nonmarket environment (Baron, 2003). It builds on Cohen and Cyert’s (1973: 352) characterization of the firm and the environment as “parts of a complex interactive system” and the assertion in Bagley (In press) that “legal astuteness”—the ability of

managers to communicate effectively with counsel and to work together to solve complex problems—is a valuable managerial capability under the resource-based view of the firm. This dynamic model rejects Baron (1995) and Aggarwal’s (2001) bifurcation of organizational context into market and nonmarket components. It treats organizations and law as endogenously coevolutionary variables and reflects the effect of managerial actions on society and on how the law is interpreted, applied, and changed over time.

The systems approach offers a bridge (Swanson, 1999: 506) between descriptive research on strategic competitive advantage and normative business-and-society scholarship. It recognizes that “business decisions consist of continuous, interrelated economic and moral components” (Swanson, 1995) and that “the moral aspects of choice” are the “final component of strategy” (Learned, Christensen, Andrews, & Guth, 1969: 578). It also builds on stakeholder theory’s insight that firms have relationships with many constituent groups, which both affect and are affected by the actions of the firm (Donaldson & Preston, 1995; McWilliams & Siegel, 2001: 118).

I first offer a critique of the traditional (Baron, 1995, 2003; Aggarwal, 2001) bifurcation of organizational context into market and nonmarket environments. The paper then presents the systems approach to business and society and explains how this approach captures the use of political strategies to shape and change the rules of the game as well as the effect of law and societal expectations on the resources of the firm, the competitive environment, and the activities that comprise the value chain. I then discuss its implications for management theory and practice and conclude with a call for interdisciplinary empirical work on the intersection of law, management, and society.

THE NONMARKET ENVIRONMENT OF BUSINESS

Baron (2003), Aggarwal (2001), and others (see literature review in Boddewyn, 2003) distinguish between what they call the “market” and the “nonmarket” environments of business. The market environment encompasses “those interactions between firms, suppliers, and customers that are governed by markets or private agreements such as contracts” (Baron, 2003: 2). In contrast, the nonmarket environment “encompasses those interactions between the firm and individuals, interest groups, government entities, and the public that are intermediated not by markets but by public and private institutions” (Baron, 2003: 2). Similarly, Aggarwal (2001: 91) defined the nonmarket environment as “the social, political, and legal context within which the firm operates.” Nonmarket issues of importance to firms include “environmental protection, health and safety, technology policy, regulation and deregulation, human rights, international trade policy, legislative politics, regulation and antitrust, activist pressures, media coverage of business, stakeholder relations, corporate social responsibility, and ethics” (Baron, 2003: 2). According to Baron (1995), “A business strategy must help a company navigate in both its market and nonmarket environments and is composed of a market or competitive component and a nonmarket or public component.” This approach is depicted in Figure 1.

Insert Figure 1 about here

Baron and Aggarwal are correct in highlighting the importance of nonmarket forces, but their bifurcation of the business environment into market and nonmarket components creates a

false dichotomy between markets on the one hand and law and societal considerations on the other. First, it fails to capture the role of law in making markets and organizations, such as corporations, possible. As North (1990), Williamson (1985), and other representatives of the new institutional economics movement have made clear, the specialization and division of labor necessary for impersonal exchange require secure property rights so parties can contract across space and time (North & Weingast, 1989). The legal system defines and enforces the property rights that determine “the balance of power among a wide variety of economic actors” (Campbell & Lindberg, 1990), and thereby affects transaction costs in the market, the need for organizations, and the efficiency of hierarchical governance mechanisms (Williamson, 1991). As Polanyi (1944: 250) explained:

“Economic history reveals that the emergence of national markets was in no way the result of the gradual and spontaneous emancipation of the economic sphere from governmental control. On the contrary, the market has been the outcome of a conscious and often violent intervention on the part of the government. . . .”

For example, Baron’s characterization of contracts as part of the market environment belies the critical role courts play in private ordering. Market forces alone are often inadequate to ensure contract performance (Klein & Leffler, 1981), making formal institutional arrangements necessary to prevent opportunistic behavior. The alternative to private dispute resolution is often the courts. As a result, bargaining typically takes place “in the shadow of the law” (Mnookin & Kornhauser, 1979). Although managers may not take most of their contractual disputes to court (Macaulay, 1962), the availability of judicial enforcement of contracts serves “as a back-up system seldom used actively, but always used passively” (Macneil, 1980: 94) to promote cooperation and the continuation of interdependence.

Second, this dichotomous model ignores a variety of legal tools that firms can use *as part of their market strategy* to create value and manage risk (Bagley, 2000, 2005, In press) and to lower costs or enhance differentiation (Siedel, 2002; Shell, 2004). These include employment contracts, proprietary information agreements, stock options, and technology licenses (Suchman, Steward, & Westfall, 2001). For example, venture capitalists often use restricted stock and stock options to align the incentives of the management team with those of the investors (Gompers & Lerner, 2001). Such arrangements can decrease the agency costs (Jensen & Meckling, 1976) arising out of the separation of ownership and control.

Edelman and Suchman (1997) call these enabling aspects of law the constitutive and facilitative legal environments. Constitutive law “constructs and empowers various classes of organizational actors and delineates the relationship between them” (1997: 483). For example, contract law determines which inter-organizational commitments are binding; tort law delineates the duties actors owe one another; and property law establishes an organization’s control over resources (Edelman & Suchman, 1997). Facilitative law establishes procedural rules and forums for organizational dispute resolution, including litigation and alternative dispute resolution, information gathering, and coalition building (Edelman & Suchman, 1997). Although Baron’s conception of the nonmarket environment captures the regulatory legal environment—the “system of substantive edicts, invoking societal authority over various aspects of organizational life” (Edelman & Suchman, 1997: 483)—it largely ignores the constitutive and the facilitative legal environments.

THE SYSTEMS APPROACH TO BUSINESS AND SOCIETY

Organizations are part of a broader system of society. Society grants rights, power, and legitimacy to business, which society can revoke if firms do not act responsibly (Wood, 1991). 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” (Glaberson, 1988). As social actors, corporations have certain responsibilities to the larger society (Hinings & Greenwood, 2002) and can act as social change agents (Bies, Bartunek, Fort, & Zald, 2007).

The systems approach, which is depicted in Figure 2, builds on Cohen and Cyert's (1973: 352) characterization of the firm and the environment as “parts of a complex interactive system,” whereby the organization affects the environment and the environment partially determines the outcomes of a variety of organizational actions. As a result, “the task of anticipating, understanding, evaluating, and responding to public policy developments within the host environment is itself a critical managerial task” (Preston & Post, 1975: 4).

Insert Figure 2 about here

Michael Porter and others have argued that “nonmarket relationships are best accounted for by folding them into the analysis of market relationships—by looking at the role of government, for instance, solely in terms of how it shapes the five (or [if one includes the role of

complementors (Brandenburger & Nalebuff, 1996)] six) forces” (Ghemawat, 2001: 35). This paper also takes an integrated approach.

The systems approach to business and society takes the top management team (TMT) of the firm, “one of the most critical resources for a successful corporate strategy” (Shanley & Peteraf, 2004: 293), as the unit of analysis. The TMT evaluates and pursues opportunities for value creation and capture while managing the attendant risks (Andrews, 1987). The risk/reward profile of an opportunity will vary depending on a variety of factors, including the skills, capabilities, and desires of the managers, the competitive environment, and the degree of regulation or deregulation (Stevenson & Jarillo, 1990). Given the characteristics of the TMT and their values (Hambrick & Mason, 1984), the parameters set by the public law, the nature and uniqueness of the firm’s resources, and the firm’s position within the competitive environment, the top management team defines the value proposition and selects and performs the activities in the value chain.

Public Law

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 (Nesteruk, 1999) social expectations. It 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. (Informal rules and customs may also affect a firm’s ability to create or capture value but are beyond the scope of this paper.) Regulatory systems and institutional assets—such as an independent judiciary and legislature bounded by a constitution; administrative agencies with the power to enact regulations, to adjudicate disputes, and to enforce laws; intellectual property regimes; and tort and product liability laws—comprise part of the firm’s position (Teece, Pisano,

& Shuen, 1997). Because “[m]oral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied” (American Bar Association, 2002: 70), legally astute managers take ethical considerations into account when trying to predict how the law will be applied to a specific set of facts (Bagley, In press).

Changing the Rules of the Game: Political Strategies

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

Because regulation can dramatically affect the environment within which organizations do business (Schuler, 1996; Shaffer, 1995), it can be advantageous for managers to develop a strategy for political action to change the public law and the way it is interpreted and applied (Aggarwal, 2001; Baron, 1995; Hillman & Hitt, 1999; Keim & Zeithaml, 1986; Shell, 2004; Yoffie & Bergenstein, 1985). This often includes lobbying legislators and members of the executive branch, forming coalitions, and working directly with regulatory bodies (Ryan, Swanson, & Buchholz, 1987; Shaffer & Hillman, 2000; Yoffie, 1987).

Organizations may actively seek regulation or deregulation to control their environment or to obtain advantages over their competitors (Stigler 1971). Under certain circumstances, a particular political strategy may result in sustained competitive advantage under the resource-based view of the firm (Hillman & Hitt, 1999).

The Walt Disney Company lobbied hard to extend the term of copyrights by twenty years to keep “Steamboat Willy,” the first Mickey Mouse film released in 1939, from entering the public domain. Firms may lobby for new laws to increase the social responsibilities of firms in a given industry and thereby place less capable firms at a competitive disadvantage (McWilliams, Van Fleet, & Cory, 2002). Organizations also make strategic choices about when and how to use litigation as competitive tools, both to shape the law to better suit their needs and to govern their interactions with individuals and organizations (Priest & Klein, 1984). Thus, law is neither explicitly the independent variable nor explicitly the dependent variable. Instead, law and organizations are “endogenously coevolutionary” (Edelman & Suchman, 1997: 501).

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

Effect of Law and Societal Expectations on Firm Resources

The resource-based view of the firm (RBV) underscores the importance of organizational factors in explaining sustained performance differences among firms (Peteraf & Barney, 2003). Firm resources, be they physical capital, human capital, or organizational capital, have the

potential of providing sustained competitive advantage if they are valuable, rare, and imperfectly imitable by competitors, and have no strategically equivalent substitutes (Barney, 1991). The “social context of resource decisions . . . affects the likelihood of optimal resource use and procurement” (Oliver, 1997).

Failure to implement appropriate processes to ensure compliance with law and satisfaction of societal expectations can prevent firms from fully realizing the value of the firm’s resources (Bagley, In press). 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 (Baucus & Baucus, 1997). Convicted firms earned significantly lower returns on assets than unconvicted firms (Baucus & Baucus, 1997). At the outer bounds, an organization’s failure to meet society’s expectations of appropriate behavior (Kaplan & Norton, 2004) or to treat stakeholders fairly (Jensen, 2001) can jeopardize the very existence of the firm.

Conversely, “conformity to social expectations contributes to organizational success and survival” (Oliver, 1997: 699). In some contexts trustworthiness may be a source of competitive advantage (Barney & Hansen, 1994), as might a reputation for integrity (Jones, 1995) and corporate social responsibility (CSR) practices, “voluntary firm actions designed to improve social or environmental conditions” (Mackey, Mackey, & Barney, 2007: 818).

Regulation may prompt firms to innovate, thereby making them more competitive (Mitnick, 1993; Porter & van der Linde, 1995). Scholars posit that a proactive environmental strategy, whereby managers “anticipate future regulations and social trends and design or alter operations, processes, and products to prevent (rather than merely ameliorate) negative environmental impacts,” is a dynamic capability that can offer competitive advantage (Aragon-

Correa & Sharma, 2003). Firms that 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 were able to translate their ability to reduce pollution into improved financial performance (Judge & Douglas, 1998; Klassen & Whybark, 1999; Nehrt, 1998).

Legally astute TMTs can protect and leverage the value of other firm resources (Bagley, In press). A properly recorded deed for real property enables the purchaser to exclude others from possession. The contractual right to renew a lease if future market conditions render it advantageous or to abandon a joint venture that has failed to meet the parties' expectations can be a valuable real option. Tax planning techniques can increase the after-tax return (Scholes & Wolfson, 1992).

Intellectual property law provides managers with various techniques to realize the value of knowledge assets (Bagley, In press), which can determine an organization's ability to survive, adapt, and compete (Leonard, 1998). Trademarks protect brand equity and a reputation for quality, which is associated with sustained superior financial performance (Roberts & Dowling, 2002). Coca-Cola Company's cola brands, which were registered as trademarks in 1905, are estimated to be worth more than \$65 billion (*BusinessWeek*, 2004). That value would quickly dissipate if the company failed to police others' use of those brands and "Coca-Cola" or "Coke" became a generic term for a cola drink.

An assignment of inventions gives the employer ownership rights in any invention or creative work conceived of or reduced to practice by its employees. Properly crafted nondisclosure agreements and reasonable covenants-not-to-compete help protect tacit knowledge and other valuable proprietary information as trade secrets. Nevertheless, reverse engineering, workplace mobility, and formal and informal technical communication can make it difficult to

protect proprietary information as a trade secret (Lieberman & Montgomery, 1988). In turbulent environments, firms must continuously innovate and remake themselves to fit changing technological and market conditions (Teece, et al., 1997).

Effect of Law on the Competitive Environment

The market environment, through opportunities and threats, determines the value of firm resources (Priem & Butler, 2001: 22). Accordingly, although the firm is the unit of analysis under the resource-based view, “a complete model of strategic advantage would require the full integration of the models of the competitive environment (i.e., product market models) with models of firm resources (i.e., factor market models)” (Barney, 2001: 49). I argue that a complete model would also have to include what has traditionally been characterized as the nonmarket environment.

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

Porter attributed his decision not to include nonmarket factors as a sixth force to the lack of a “monotonic relationship between the strength and influence of government power and the profitability of industry” (Argyres & McGahan, 2002: 46). Nonetheless, in his more recent work, Porter acknowledged that societal conditions form a key part of the competitive context and thereby affect a firm’s ability to improve productivity and execute its strategy over the long term (Porter & Kramer, 2006: 84). He also addressed them in his diamond of national advantage, which is discussed below.

Regulatory changes can affect the structure of an industry and provide opportunities for establishing competitive advantage (Leone, 1981). Travelers Insurance and Citibank dramatically changed their regulatory environment when, after seeking and receiving the tacit approval of Federal Reserve Board Chairman Alan Greenspan, they merged to form Citigroup in 2002 then helped persuade Congress to amend the Glass-Steagall Act and the Bank Holding Company Act to permit commercial banks to underwrite securities and insurance (Cox, 1999; Langley, 2003; Wilmarth, 2002).

Law and the Value Chain

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.

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

Insert Figure 3 about here

Corporate law constructs and defines the characteristics of particular organizational structures, such as a for-profit corporation or a partnership. Bankruptcy law prescribes the priority of an organization's competing obligations to its debt and equity holders (Edelman & Suchman, 1997). Laws offering limited liability to investors, giving entrepreneurs fresh starts after filing for bankruptcy, and promoting transparency in the capital markets facilitate the marshaling of financial capital.

Choice of business entity will determine whether the investors have limited or unlimited liability; how active investors can be in managing the firm without losing limited liability; how easily transferable ownership interests are; whether tax is paid at just the owner level or at the firm level as well; and how power is allocated between the managers and the equity holders. For example, the availability of a limited partnership as a form for organizing a venture capital fund and of convertible preferred stock, with a variety of rights, preferences and privileges, were key to the growth of the U.S. venture capital industry (Sahlman, 1990). Corporate law also affects the allocation of firm resources among stakeholders. Antitakeover devices and constituency statutes shift power from the shareholders to the board of directors by giving the board the ability to

block a proposed change of control or sale of assets favored by the shareholders (Bagley & Page, 1999). Judicial decisions that increase the directors' exposure to personal liability for corporate decisions affect corporations' ability to attract and retain qualified independent directors (Kaplan & Harrison, 1993).

Court cases permitting employment at-will while requiring the payment of damages for wrongful termination and statutes banning employment discrimination affect the firm's ability to marshal human resources, as do laws enforcing or prohibiting certain noncompete agreements. The Fair Labor Practices Act regulates the minimum wage, overtime pay, and the use of child labor. The National Labor Relations Act granted employees the right to form unions and take other collective action to secure better wages and working conditions but also curbed union excesses and corruption. The state workers' compensation statutes provide employees no-fault monetary coverage for medical expenses and lost income resulting from workplace accidents or illness. The Employee Retirement Income Security Act (ERISA) regulates pension plans and many other types of employee benefit plans. Within the bounds established by these and other laws, employers can craft the employment relationship best suited to their needs.

Statutes, such as 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 which terms govern a sale of goods when the order and invoice contain conflicting terms, 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. Courts will enforce such provisions as long as they do not allocate risk in an objectively unreasonable manner.

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

Potential legal liability also affects the boundaries of the firm. Barney, Edwards, and Ringleb (1992) found that exposure to liability stemming from employees' on-the-job exposure to hazardous materials made firms more likely to adopt a non-vertically integrated production system.

The Importance of Fit

As is the case with strategic human resource management (Delery & Doty, 1996; Mahoney & Pandriam, 1992; Wright, Smart, & McMahan, 1995; Wright & Snell, 1998), competitive advantage should be more readily attained when a firm's legal and CSR practices are effectively integrated with its business strategy. Consider the practice of at-will employment in

the United States whereby an employee may be terminated by the employer at any time for any or no reason. Pfeffer (1994) 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 through its workforce” (Pfeffer, 1994: 147). Firms that adopt a “litigation mentality” (Bies & Tyler, 1993) may inadvertently undermine their human resource management strategy by increasing control mechanisms and enacting formal policies that interfere with the interpersonal exchanges required for the production of trust and thereby inhibit organizational proactiveness and flexibility (Lado & Wilson, 1994). This suggests that managers who view their employees as sources of competitive advantage should be especially careful not to delegate responsibility for setting their human resources policies to their lawyers.

The Diamond of National Advantage, Societal Context, and Change

Multiple-country studies reveal that the efficiency of a country’s capital markets is directly related to the country’s institutional environment (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998). Adequate protection of minority rights increases investment in new ventures (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). A country’s economic prosperity—measured by the per capita gross domestic product (GDP)—is directly correlated with certain legal protections (Porter, 2002). Researchers found a statistically significant relationship between per capita GDP and each of the following:

- Judicial independence
- The adequacy of legal recourse
- Police protection of business
- Demanding product standards

- Stringent environmental regulations
- Quality laws relating to information technology
- The extent of intellectual property protection
- The effectiveness of the antitrust laws (Porter, 2002).

Conversely, excessive regulation, including burdensome licensing requirements and filing fees, can hamper new venture formation (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002).

Porter included the legal system and legal rules in his “diamond of national advantage” (Porter, 1996b: 166). He postulated that there are four broad attributes of a nation that, individually and as a system, establish the playing field for local industries: (1) factor input conditions, such as natural and human resources; (2) demand conditions, such as the nature of the home-market demand for the industry’s products; (3) the presence or absence of related and supporting industries, such as suppliers; and (4) the context for firm strategy and rivalry (Porter, 1996b: 166). The systems approach captures the legal aspects of each.

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

The context for firm strategy and rivalry includes the “rules, incentives, and norms governing the type and intensity of local rivalry” (Porter, 1996a: 211). These include laws and policies affecting both (1) the climate for investment, such as the corporate governance system, labor market policies, the tax system, and intellectual property rules and enforcement, and (2)

local rivalry, such as openness to trade and foreign investment, antitrust policy, and licensing rules (Porter, 1996a).

In his later work, Porter called on managers to use the same company-specific frameworks that guide their core business choices to analyze their prospects for corporate social responsibility (Porter & Kramer, 2006). Rather than trying to take on all the ills of the world, companies should, according to Porter and Kramer, focus on social issues that intersect with their particular business and value proposition. They should first eliminate as many negative value-chain impacts, such as emissions and waste and depletion of scarce natural resources, as possible. Second, they should identify areas of the social context where they can create “shared value” for the firm and society through a small number of initiatives that both generate competitive advantage for the firm and benefit society (Porter & Kramer, 2006: 88). Examples include Toyota’s Prius, a hybrid electric/gasoline vehicle that both reduced emissions and gave Toyota a distinct position with customers (Porter & Kramer, 2006: 88-89), and Whole Foods Market’s ability to charge premium prices for healthful food products that are (1) sourced from local farmers, (2) sold in stores constructed with a minimum of virgin raw materials and utilizing electricity that is offset by renewable wind energy credits, and (3) increasingly delivered in trucks powered by biofuels (Porter & Kramer, 2006: 90-91). By integrating societal considerations in a single model of the firm and its environment, the systems approach should enhance managers’ ability to craft a truly integrated firm strategy for creating and capturing value.

IMPLICATIONS FOR MANAGEMENT THEORY AND PRACTICE

This paper drew on theory and research from disparate areas to present a descriptive integrating framework of business and society. The systems approach embeds the top management team in the societal context. It draws on earlier research that shows how the societal context, including the institutions that “define and limit the set of choices of individuals” (North, 1990: 3-4) and the interrelationships between legal and economic processes (Samuels, 1989), affects firm creation (LaPorta, et al., 1997) and performance (Porter, 1996b).

We know that the manner in which managers are trained to understand their world affects their behavior (Baron & Hannan, 1994; Ferraro, Pfeffer, & Sutton, 2005) and that the mindsets and actions of practicing managers hold the normative and descriptive together (Swanson, 1999: 518; Donaldson, 1999). Scholars have found that economics students, who are taught the norm of self-interest, are more likely to free ride (Marwell & Ames, 1981), keep more resources for themselves in an ultimatum game (Carter & Irons, 1991), defect in a prisoner’s dilemma game (Frank, Gilovich, & Regan, 1993), and be corruptible (Frank & Schulze, 2000). By teaching students that everyone else will act in their own self-interest, economics courses encourage students to act that way for fear of “appearing foolish, gullible, or naïve” (Ferraro, Pfeffer, & Sutton, 2005: 14).

Similarly, the bifurcation of the environment into market and nonmarket components arguably affects managers’ conception of how the world works and thus their behavior. By divorcing markets from the institutions that make them possible and ignoring institutional arrangements, societal expectations, and legal tools, the traditional dichotomous approach threatens both to deprive managers of their legal and ethical compass and to miss opportunities to use the law and CSR practices to manage the firm more effectively.

In contrast, the systems approach should help ensure that managers keep societal considerations and legal opportunities “top of mind” when filtering information and interpreting stimuli (March & Simon, 1958) and deciding how to act. As a result, managers exposed to an integrated approach that makes explicit the societal context of business, the importance of the rule of law to efficient markets, and the accreting value of legal tools should manage differently from those trained to focus on just economic returns for shareholders. In particular, a top management team that incorporates legal and societal considerations in its value chain should be better equipped to create “shared value” (Porter & Kramer, 2006) for the firm and society than one that first establishes the business strategy then runs it by counsel to ensure that it does not violate the letter of the law.

AREAS OF FUTURE RESEARCH

This paper embedded legal considerations and societal expectations in mainstream theories of competitive advantage in an effort to explain how law and the societal context affect the boundaries and resources of the firm, the competitive environment, and the activities in the value chain. It recognizes the importance of (1) the unique resources of the firm and other organizational variables, (2) the characteristics of the competitive environment, (3) the values of the top management team, (4) the complex and “messy” (Nehrt, 1988: 94) but rich context within which managers actually operate, and (5) the role of fit in achieving competitive advantage. The systems approach rejects the bifurcation of organizational context into market and nonmarket components. It makes explicit the role law plays in creating markets and firms but does not treat law as totally exogenous to markets or firms. Instead, it provides a descriptive integrating framework for understanding how legally astute managers can, as part of their

business strategy, use various legal tools and CSR practices to select and perform the activities in the value chain and help shape the environment in which they do business.

We know that certain attributes of the top management team (Hambrick & Mason, 1984) and certain CSR practices (Margolis & Walsh, 2003) are sometimes associated with superior financial performance. Existing studies of the relationship between financial performance and CSR practices have generated mixed results, however (see literature review in Barnett, 2007; McWilliams & Siegel, 2001; Margolis and Walsh, 2003). McWilliams and Siegel (2001) attributed this inconsistency to the lack of a model linking CSR to market forces. The systems approach offers a framework for analyzing the moderating effect of the fit between a firm's legal and CSR practices and its resources and competitive environment in a more nuanced manner.

Empirical studies could examine whether there is in fact a correlation between the TMT's understanding of the importance of the societal context and law on the one hand and the firm's financial performance on the other. They could also determine whether factoring in (1) the relationship between a firm's core business activities and its CSR practices, (2) the competitive environment, and (3) the firm's resources affects the direction or degree of correlation between CSR practices and financial performance.

My hope is that this framework will both (1) help managers manage more effectively and responsibly and (2) enable scholars in strategy, business and society, and law to work together both when analyzing managerial performance and prescribing how managers should act to meet societal expectations. Future interdisciplinary empirical work will test the framework presented in this paper and almost certainly require its further refinement.

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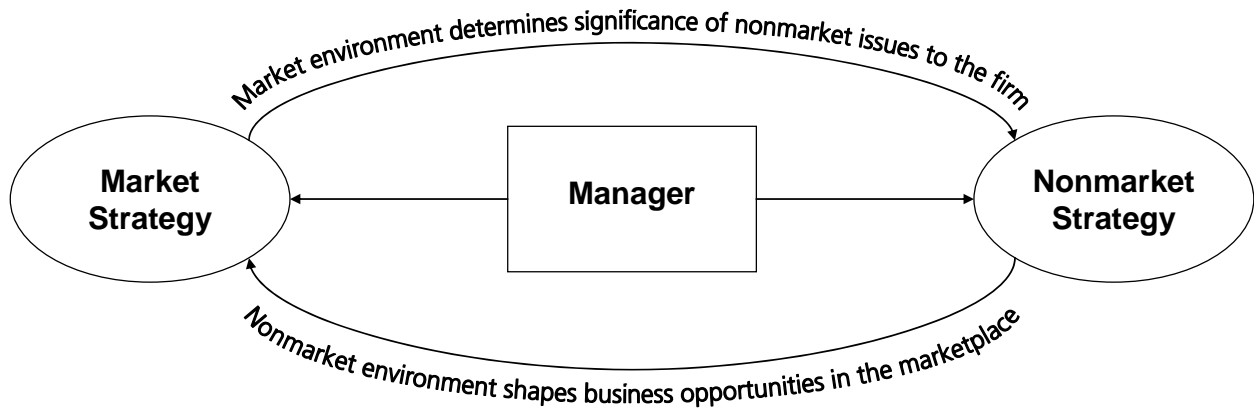
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FIGURE 1

Baron's Model of Market and Nonmarket Strategies



Source: Baron, 2003: 2.

FIGURE 2

Systems Approach to Business and Society

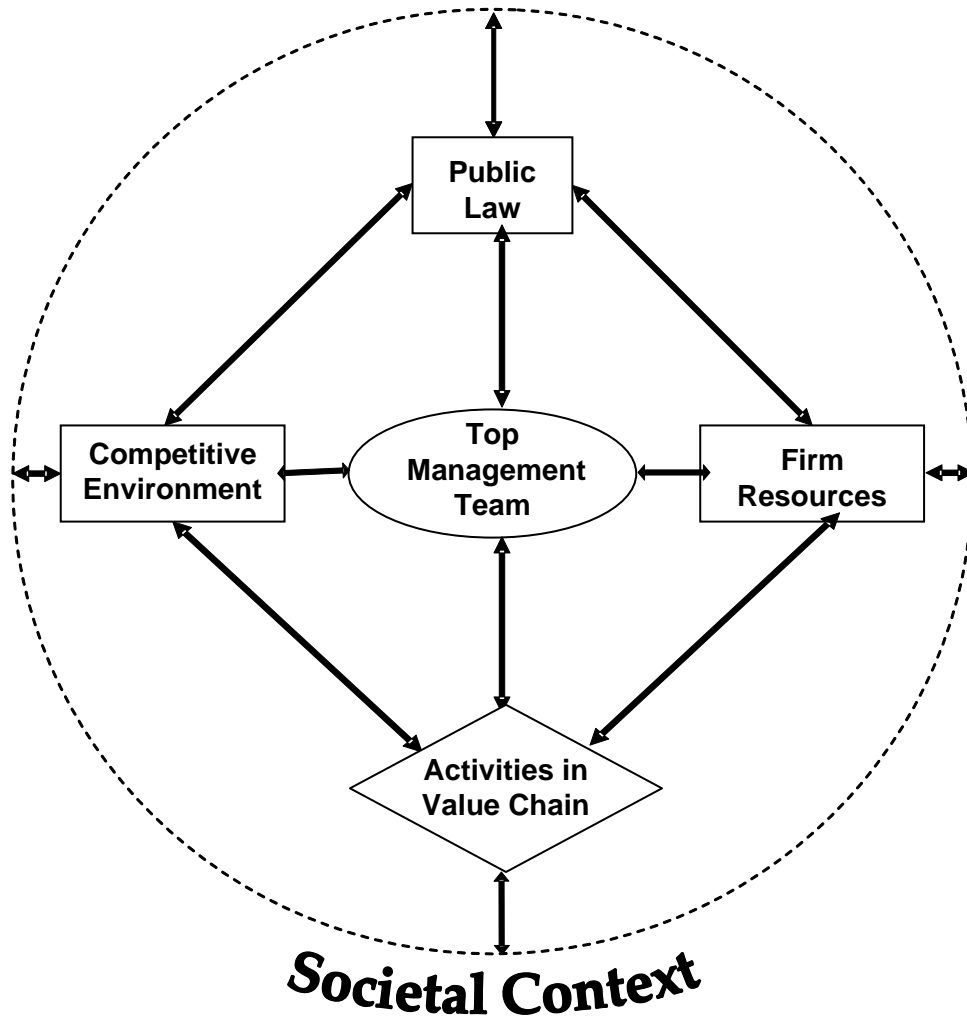


FIGURE 3

Law's Role in the Value Chain

Support Activities	Firm infrastructure	<i>Limited liability, corporate governance, choice of business entity, tax planning, & securities regulation</i>				
	Human resource management	<i>Employment contracts, at-will employment, wrongful termination, bans on discrimination, equity compensation, Fair Labor Practices Act, National Labor Relations Act, workers' compensation, & Employment Retirement Income Security Act</i>				
	Technology development	<i>Intellectual property protection, nondisclosure agreements, assignments of inventions, covenants not to compete, licensing agreements, & product liability</i>				
	Procurement	<i>Contracts, Uniform Commercial Code, Convention on the International Sale of Goods, bankruptcy laws, securities regulation, & Foreign Corrupt Practices Act</i>				
Primary Activities	Inbound logistics	Operations	Outbound logistics	Marketing and sales	Service	Margin
	<i>Contracts</i> <i>Antitrust limits on exclusive dealing contracts</i> <i>Environmental compliance</i>	<i>Workplace safety & labor relations</i> <i>Environmental compliance</i> <i>Process patents</i>	<i>Contracts</i> <i>Environmental compliance</i>	<i>Contracts</i> <i>Uniform Commercial Code</i> <i>Convention on the International Sale of Goods</i> <i>Consumer protection laws, including privacy protection</i> <i>Bans on deceptive or misleading advertising or sales practices</i> <i>Antitrust limits on vertical and horizontal market division, tying, and predatory pricing</i> <i>Import / export controls</i> <i>World Trade Organization</i>	<i>Strict product liability</i> <i>Warranties</i> <i>Waivers & limitations of liability</i> <i>Doctrine of unconscionability</i> <i>Customer privacy</i>	

Sources: Diagram and text in roman from Porter, 1985; text in italics adapted from Bagley, 2005: 12 and Porter & Kramer, 2006.