



How Companies Use (and Abuse) Law for Competitive Gains

Published : May 19, 2004 in [Knowledge@Wharton](#)

As the main character in Mario Puzo's novel *The Godfather* once put it, "The lawyer with his briefcase can steal more than a hundred men with guns." Perhaps this explains why many business schools require future business leaders to study legal and political strategy as well as marketing and finance. Consider the following:

- Wal-Mart's bid to enter the California grocery market has been blocked by coalitions of unions, small business lobby groups and anti-sprawl groups, who mobilized voters to turn away Wal-Mart ballot initiatives to bypass local planning boards.
- Medco Health Solutions, the largest pharmacy benefits management company in the United States, last week settled lawsuits brought by state and federal authorities by agreeing to stop switching patients over to more expensive drugs not prescribed by their doctors (these drugs were favored by Medco because of private "rebate" agreements with drug manufacturers). Medco also pledged to begin disclosing its rebate practices to employers, doctors and patients.
- The hi-tech market has been roiled by several prominent legal battles, including SCO Group's attempt to litigate its way into control of the Linux software market. Linux, the open-source alternative to Microsoft's "Windows" operating system, is under threat because SCO claims that it owns the copyright to a key piece of Unix computer code embedded in Linux.



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

A new book by Wharton legal studies professor [G. Richard Shell](#), called *Make the Rules or Your Rivals Will*, translates moves like these into the language of corporate strategy – explaining the 10% of law and politics that makes 90% of the difference to business decision makers. Shell's thesis centers on what he calls "competitive legal strategy" – the use of contracts, courts, regulation, and lobbying to secure competitive advantage in business. He shows how Sumner Redstone, Rupert Murdoch, Andy Grove, and Bill Gates, among others, have forced rivals to the bargaining table with litigation, defined the boundaries of their markets with regulations and used politics to fight competitive battles. Nor, Shell notes, is this a recent development. Long before SCO Group tried to gain control over the Linux market with copyright lawsuits, the first manufacturers of sewing machines, automobiles, radios, and even airplanes perfected litigation strategies to control their respective industries. Shell uses examples from business history to illustrate his thesis.

In the following excerpt from *Make the Rules or Your Rivals Will*, Shell shows how the leaders of the hi-tech memory chip market in the 1980s reached into their playbook of legal moves to meet the challenge of Asian computer chip manufacturers entering the U.S. market. The story is typical of the way legal and business strategy tactics work in tandem in high-stakes crises and illustrates Shell's "Five Factors of Legal Strategy Success" in business situations.

In 1985, the market for these chips (so-called DRAMs) was collapsing. The chips had been at the cutting edge of technology in the 1960s and 1970s. But as the 1980s rolled in, firms were cramming more and more memory onto every chip and global manufacturing capacity was exploding. Cheap Japanese and Korean chips flooded the U.S. market, driving prices down and leaving U.S. firms with painful losses.

In boardrooms across America, top executives huddled in all-night sessions trying to determine whether to stand and fight or cut their losses. It was, as Intel's Andy Grove was later to call it, a critical leadership moment -- a "strategic inflection point" in the chip business. The strategic decisions of four key players in this market -- Intel, Micron Technologies, Texas Instruments, and Mostek -- were to define the future of microchip manufacturing in the United States.

At Intel's offices in California's Silicon Valley, Gordon Moore and Andy Grove, CEO and president respectively, sat in Moore's office mulling over Intel's options. Intel was a leading manufacturer of memory chips, with billions invested in factories and research. Moore was the author of the famous "Moore's Law," which had predicted accurately that the number of transistors on a chip would double every two years. A year earlier, in 1984, *Fortune* magazine had named Grove as one of America's toughest bosses. Historian H. W. Brands tells us what happened next:

Grove looked out the window to the Ferris Wheel of the Great American amusement park across the way, and perhaps reflected that the company was going in similarly aimless circles. He turned to Moore with a question. "If we got kicked out and the Board brought in a new CEO, what do you think he would do?" Moore answered, "He would get us out of memories." Grove reflected for a moment. Then he said, "Why shouldn't you and I walk out the door, come back and do it ourselves?"

So that is just what Intel did, exiting the memory chip market altogether and moving exclusively to microprocessors, the new chips that were powering the hot-selling personal computers made by IBM and its "clones." Competitors Motorola and National Semiconductor soon followed Intel's lead.

To the east, in Boise, Idaho, executives at Micron Technologies looked at the same competitive landscape and reached for legal tools to fight back at their new adversaries. As a firm serving an exclusive base of U.S. customers, exiting or cutting prices further were out of the question. So Micron turned to the time-honored regulatory remedy for fighting cheap imports that Joseph Wharton and others had perfected in his 19th century battles to save the steel industry: protective tariffs.

In consultation with trade officials in the Reagan administration, Micron hired Washington lawyers and filed an "anti-dumping" complaint with the Department of Commerce. Micron alleged that Japanese and Korean firms were selling chips in the U.S. market at a loss, seeking to drive firms like Micron out of business so they could have the market to themselves. Anti-dumping complaints trigger a complex, multi-tiered legal proceeding that can result in penalties that raise the price on "dumped" goods to levels that protect the market share of domestic producers. Micron also lobbied the Reagan administration to take action, and the U.S. government soon filed its own anti-dumping complaint against these same Japanese and Korean chipmakers.

Meanwhile, to the south in Dallas, Texas, the leaders of Texas Instruments (TI) found a much more innovative -- and profitable -- legal solution to the crisis. Encouraged by an in-house lawyer named

Melvin Sharp, TI decided to attack the Asian invaders with patent litigation. Sharp, a lawyer with an engineering degree and four years of experience as a patent examiner for the U.S. Patent and Trademark Office, suggested that TI alter its entire approach to mining intellectual property.

TI had been a pioneer in the chip field, holding the first patents on both the basic integrated circuit and the microprocessor. As Sharp was later to describe TI's 1985 decision process, "We spent six months in weekly and sometimes daily discussions on how to respond to this particular challenge. One of the things that emerged was that we had intellectual property rights here, we had created this market, and now we were being driven out of the market. And we thought that was just unfair...[I]t was time to use our [patents] to protect the market we had created."

This represented a basic change in the way TI -- and most other high-tech firms at the time -- thought of patents. In 1985, as Sharp explained, "Patents were perceived as trading materials to get free use of someone else's intellectual property. So people just cross-licensed it." In other words, in the fast-moving world of high technology, companies did not use patents as weapons to punish infringers but rather as bargaining chips to gain access to others' innovations.

The chip crisis prompted TI to turn its intellectual property into a source of competitive advantage, transforming TI's basic profit model from one that depended on selling its own chips to one that harvested profits from patent royalties on the sales of *everyone else's* chips. TI was about to set up a litigate-and-license "tollgate" at the entrance to the U.S. memory chip market. The strategic goal was not to block competitors as Micron was seeking to do, but rather to charge competitors a hefty access fee.

Sharp quickly assembled a team of technology lawyers and engineers. For months, this team surveyed all TI patents on memory chips and painstakingly reverse-engineered every DRAM chip from Japan and Korea searching the intricate architecture of these chips for designs that infringed TI's patents.

With its preparations complete in early 1986, TI faced its next decision: which should it do first -- litigate or negotiate? The strategy team reasoned that the Asian firms would probably try to turn any negotiations into an endless round of talks that would go nowhere, so it decided to sue first and ask questions later. "The normal, gentlemanly way to do [litigation] is to go out, put people on notice, and talk to them about the proposed new rates," explained Sharp. "That's not what we did. We filed suit first ...and I'll tell you the shock was huge. You could hear the gasps from Tokyo all the way to Dallas."

TI launched a patent litigation campaign against the Japanese and Koreans on a scale the industry had never seen. It sued nine companies simultaneously -- Hitachi, NEC, Mitsubishi, Matsushita, Oki, Fujitsu, Toshiba, Sharp, and Samsung. And it filed cases against these defendants in two different forums: federal district court in TI's hometown of Dallas, Texas, and the International Trade Commission (ITC) in Washington, D.C., which has jurisdiction to hear claims against importers bringing goods into the United States that might violate U.S. patents. The federal district court in Dallas had jurisdiction to award damages for past patent infringement. The ITC had the power to bar the defendants from selling their chips in the United States in the future -- at any price.

As both cases moved forward in the litigation process, TI negotiators hit the road, initiating discussions not only with the defendants but also with Japanese regulators and American ambassadors in Japan and Korea. A legal attack this big was bound to have political after-shocks, and TI wanted to be sure everyone was informed of its motives and goals.

As the initial shock wore off, the defendants began to understand that, strategically, they were all in the same boat. TI was asking for roughly equal royalties from each defendant, so all of them would feel the same bite on their profits. Moreover, TI's lawsuit in the International Trade Court might result in their being completely shut out of the U.S. market, an unthinkable alternative for Asian firms concerned with maintaining high employment in their home factories.

They gradually lined up to seek settlements. The hearings on the cases, which began in March 1986, were still underway in November when Sharp Electronics settled its cases and agreed to pay a steep licensing fee. The other seven Japanese defendants settled soon after. Only the Korean firm Samsung held out. But it, too, settled when the ITC judge upheld TI's patents for two key chips.

The TI campaign was a landmark in high-tech legal strategy. *Forbes* magazine later estimated that in over three years of litigation, TI employed 29 different law firms and nearly 350 lawyers. But the licenses TI negotiated more than vindicated the company's investment in these legal capabilities. The nine deals yielded \$1 billion in royalty income spread over the five-year term of the settlement agreements.

Moreover, with these successes behind it, TI aimed its new litigation guns at additional targets -- U.S. and European firms that had built chip designs using TI's patented models. "If we were going to get Japanese and Koreans," said Sharp, "we needed to treat Americans and Europeans the same way." In 1992, TI's patent portfolio returned more revenue -- \$391 million -- than did all its other operations combined.

Indeed, by 1993, Intel itself -- now led by Andy Grove as CEO -- had adapted TI's pugnacious legal style to become one of the most aggressive litigators in the industry. Unlike TI and Mostek, however, Intel's goal was to monopolize the microprocessor market, not license to it. As Intel led (and profited from) each successive stage in the evolution of the personal computer, from the 8086 chip to the Pentium series, Grove fearlessly directed Intel's large legal team to use copyright, trade secret, and patent law to keep its imitators as far behind its learning curve as possible, investing by one estimate as much as \$100 million in litigation. Grove himself put it this way: "We have gone to court to protect our intellectual property from competitors who would have liked to help themselves to it. I understand that you don't make friends that way."

While one may be tempted to think that the patent litigation innovations of the 1980s and 1990s were a unique episode in business history, they were not. Companies have been profiting from innovative legal strategies almost as long as the modern market has been around. The Sewing Machine Patent Pool of the mid-1800s (in which all the major sewing machine companies cooperated to form a single cartel) was as innovative in its day as TI's litigation machine was for its. Research discloses that the birth of every new market segment -- from farm equipment in the 19th Century to open source software in the 21st Century -- is accompanied by major shifts in the legal rules that govern business. Being at the bargaining table where the rules are made can yield sustainable competitive advantages for decades.

Overall, five key factors seem to be associated with legal strategy success in business: the legal merits of one's rights, the "legitimacy" of the arguments one can make in the court of public opinion, the strategic positions occupied by the various rivals facing off against one another, the relative resources of the disputing parties, and which side has favored access to legal decision makers. The memory chip example confirms the importance of each of these factors.

Factor #1: **The Merits.** TI's litigation strategy ultimately hinged on the validity of its patents. Although most of the Asian firms settled their cases before a court ruled on TI's petitions, Samsung held out and put TI to the test. When the International Trade Court upheld two of TI's memory chip patents, Samsung folded. The rest of the memory chip market quickly fell into line, and hundreds of millions of dollars flowed to TI.

Factor #2: **Public Legitimacy.** The U.S. memory chip manufacturers exploited the fact that the new entrants were foreign companies invading American markets and threatening U.S. jobs. An effective media campaign was an integrated part of the strategy. Public sympathy enabled the chip industry to lobby successfully for government protection and cast the Americans as the "victims" of unfair trade practices.

Factor #3: **Strategic Position.** Neither TI nor Micron had existing contracts with their Asian counterparts to buy or sell chip components. This meant they were free to use legal strategies against the Asian firms without fear of contractual reprisal. Moreover, as incumbents in the U.S. market, they could call on business allies from across a wide range of corporate sectors that were also facing foreign competition.

Factor #4: **Resources.** TI's litigate-and-license strategy required significant resources. A smaller company or start-up could not have sustained the \$10 million in legal fees needed to establish credibility for TI's patents. And the sheer expense of defending these actions was doubtless a factor in the decisions by most of the Asian companies to settle before a court issued a definitive ruling on the merits of TI's legal claims.

Factor #5: **Access.** Effective lobbying by the relevant high-tech associations and access to high officials in the Reagan White House were key to persuading the U.S. government to file its anti-dumping complaint against the Asian chip companies. The competitiveness of American industry was a major political issue at the time of these events, and many saw the high-tech sector as the best hope for sustaining U.S. economic growth. In addition, it was no coincidence that TI filed one of its lawsuits in its home state of Texas. There is plenty of research that shows how the home court advantage can spell the difference between victory and defeat in litigation.

Law is perhaps the most hidden of all competitive strategy tools. Many in business fear getting tangled up with lawyers, lobbyists, and bureaucrats, so they keep their distance from legal matters. But it is just this aversion that makes legal knowledge such a rich source of competitive advantage for those who take the time to understand how legal systems really work.

Someone, after all, is going to make the rules. The only question is who.

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.