In 1999, Hilary Rosen, then chief executive of the Recording Industry Association of America (RIAA), gathered the heads of the major music labels in the United States around a table at the Four Seasons Hotel in Los Angeles to discuss what to do about digital music. Instead of rehearsing legal arguments, she simply asked those present to name songs – anything from their latest hits to their back catalogs – and with a computer in front of her, she proceeded to show them that every single song they could think of was already available on Napster, the online file-sharing service. The music executives were stunned – and not just a little worried. What would this mean for their bottom lines?

Ten years later, the music industry is still in a quandary – and their bottom lines are still shrinking, from $13 billion in sales in 1999 to $8 billion last year. The only thing clear is that the traditional distribution model cannot hold, yet large music companies are clinging on, waging an unpopular and ultimately self-defeating battle against illegal downloads. Yes, the RIAA sued Napster and shut it down, but, as many companies are learning the hard way, you can win a battle and still lose the war, especially when the rules of the battlefield have changed so completely.

In recent interviews, Hilary Rosen has ex-
pressed regret over Napster’s demise, seeing it as a lost opportunity: the industry was too slow to take advantage of it, to embrace it, and now new entrants, such as Apple, are taking a leading role in the industry by providing a user-friendly platform for legally downloading copyrighted material. Other players are experimenting with radically different business models, such as free ad-supported music (MySpace, YouTube, imeem), music-as-service (Rhapsody) or a mix of the two (Spotify).

Regardless of which dominant model emerges, the traditional music labels are now in a much tougher position. According to Tim Quirk, vice president of music programming for Rhapsody, they only have themselves to blame. In an NPR interview in October 2009, he described it this way: “They know what their catalog was worth in the past. They know what it’s worth today. They do not know what its future value will be, so their job is to maximize its present-day value. The big fear is not so much a loss of money as a loss of control. MTV was a huge success. Labels still hate MTV because they felt like MTV was building a business on their backs. You hear a lot of the same kind of talk with the success of iTunes. Even though it’s putting big paychecks in the record company coffers, they’re still upset that it’s got so much power over them.”

So what should RIAA members have done? What should any business leader do when the whole architecture of their industry is suddenly up for grabs? When all the players are experimenting with vastly different roles, and the distribution of value across players is far from being settled, the key may be to become the bottleneck in the chain, thereby keeping more of any value created. A novel industry architecture, as we shall explore in this article, is not necessarily a bad thing – if you can succeed in reshaping it to your advantage.

**The Concept of Industry Architecture**

Technological and regulatory changes have been shown to have a dramatic impact on the structure of industries and their competitive dynamics. Consider how the digital era is reshaping the music industry, or how profoundly deregulation has changed the telecommunications sector. However, the specific shape that industries take is not purely determined by these exogenous “shocks,” but is influenced by the decisions that managers make in response to these shocks.

The concept of “industry architecture” as proposed by Michael G. Jacobides might help managers face these challenges. An industry architecture essentially consists of (1) a template defining how labor is divided, and value created, in the industry – who does what; and (2) a template defining value appropriation and division of surplus – who gets what. These templates define the roles and rules followed in a specific industry, and they are reinforced by technological or institutional factors. Technological standards, for instance, might require two companies to collaborate in a production process, which ends up defining their respective roles in the value chain. Likewise, strong regulatory or social norms about what is expected of an actor may contribute toward defining the division of labor between firms and the distribution of profits.

Industry architecture, therefore, both constrains the action of competitors by defining
formal and informal rules for competition and roles for interactions, and provides opportunity for entrepreneurial players to build a more favorable competitive position, when environmental shocks create an opportunity to renegotiate them.

This article attempts to address such questions surrounding emerging architectural advantage by analyzing the historical case of Lew Wasserman. From 1939 until 1965, Lew Wasserman and his company, Music Corporation of America (MCA), managed to change the competitive landscape of the motion picture industry in the United States completely. They exploited technological and regulatory changes and wielded enormous influence until the 1980s.

The Rise of Lew Wasserman
At the time of his death in 2002, Lew Wasserman was not widely known outside of the confines of the movie industry. Despite being the most powerful movie mogul in Hollywood and a powerful player in national politics, very little had been written on him. Since his death, three biographies have been published, but much of the attention has been on his influence in Washington, D.C., especially since the 1960s, rather than on his role as a business strategist.

Nevertheless, during the first three decades of his career, from 1939 until the mid-1960s, Wasserman reshaped the motion picture industry in the United States and took MCA from a peripheral player in the talent-agency business to becoming the dominant studio in Hollywood. As Jack Valenti, the long-reigning president of the Motion Picture Association of America (MPAA), once put it: “If Hollywood was Mount Olympus, Lew Wasserman is Zeus.”

In 1936, at the age of 23, Wasserman joined MCA, which was a successful band-booking agency based in Chicago. Three years later, he moved to Los Angeles to help Jules Stein, MCA’s founder and president, build up the movie side of the business. At the time, the movie industry was vertically integrated, and most actors, directors and writers were salaried employees of the studios, typically under seven-year contracts. Given this situation, an agency like MCA could help these talents break their studio contracts and negotiate better ones with other studios on a project-by-project basis. MCA started acquiring stars’ contracts.

The established Hollywood players, such as the Selznicks, William Morris and Famous Artists Agency, did not see the opportunities to be had. They remained focused on signing new talent for radio, vaudeville acts, clubs and theater, which they regarded as more lucrative businesses, given that the studios’ traditionally strong position in Hollywood seemed sewn up. As Wasserman noted, “They felt they didn’t need to (buy stars’ contracts), they were kings (…) it was beneath them.” Given this, the incumbents were more than happy to see this business going to MCA. Only after MCA had proven that representing movie talent could be truly profitable did the other players take notice. But by then, MCA had consolidated its position.

Two disruptive changes in the movie industry created the opportunity for Wasserman to profit from the investment that MCA was making in talent: the 1948 Paramount decree and the rise of television.

1. A REGULATORY SHIFT GIVES RISE TO INNOVATIVE PRACTICES. During the so-called Studio Era of the 1930s and ’40s, most of the talent, as well as the financing, production and distribution of movies, was controlled by five major studios: MGM, Paramount, Fox, Warner Brothers and RKO Radio Pictures. Most importantly, these studios owned practically all the theater chains
across the country in which to show their films. This put independent theater owners at a major disadvantage: They needed to operate at full capacity just to stay afloat, but the only way they could obtain popular features was by entering into contractual relationships with the majors. The studios took advantage of the independents’ limited bargaining power, forcing them to accept movies in blocks without being able to screen them in advance. In this way, crowd-pleasers were bundled together with substandard B-movies, ensuring that even the most dubious of studio output found an audience somewhere. This vertically integrated architecture enabled the studios to exploit all of their resources fully.

But, as often happens in business, this gravy train was about to hit the end of the line. The U.S. Department of Justice began investigating the industry’s oligarchic practices, issuing stern warnings against the unsustainable practices that were holding everyone hostage to five big players. This eventually led to a landmark case, United States v. Paramount Pictures, Inc., in which the U.S. Supreme Court ruled that the existing arrangement was in violation of antitrust regulations. The 1948 Paramount decision forced exhibition to be separated from production and distribution. The five majors were ordered to divest their theater holdings.

This decision broke the stranglehold of the studios, giving independents more control over their own operations. Since the studios couldn’t control the production and exhibition channels anymore, they had no choice but to slash their output by half. The studios had to let go of their talent, and the decade following this ruling witnessed dramatic cutbacks, with the number of actors under contract with major studios going from 804 to 164; directors, from 99 to 24; producers, from 149 to 50; and writers, from 91 to 47.

Enter Lew Wasserman, whose slow and steady practice of courting talent early on landed MCA in pole position. Wasserman did not just reap the benefit from his control of talent; he also introduced two innovations that would reshape the entire industry: profit sharing and packaging.

Profit sharing for talent had been done in the past, but it is only with Wasserman that the practice took off and became institutionalized across the industry. The practice helped MCA strengthen its relationship with the talent, and took advantage of the studios concern with costs, and their need for stars, by sharing box-office risks and rewards with them.

In addition to the diffusion of profit-sharing contracts, MCA also began packaging the scriptwriters, directors, stars, producers and other talent for movie productions. MCA had no control over the actual movies, nor did it have any financial stake in the finished products. But packaging facilitated the shift in filmmaking authority, especially the initiation and development of movie projects, away from the studios and into the hands of individual filmmakers.

Packaging and profit sharing became the building blocks of a novel industry architecture in which studios were now focused on the financing and distribution of movies. Independent producers, and occasionally talent agencies, were producing pictures, often renting the studios’ facilities, and talent agencies were much more central in the flow of exchanges, given their control of creative talent. The emergence of this new architecture was in response to an exogenous environmental shock: the Paramount decree and the studios’ loss of control over exhibition. Nevertheless, this configuration of actors and activities was not a natural consequence of these shocks, but rather the emergent outcome of the interacting players.

The introduction of two novel practices enabled the shifts in roles that the players experienced, and later reinforced these new rules of the game. Wasserman played a critical part in this architectural shift by introducing the novel practices and, given his control of the
creative talent, reaped most of the benefits. In this sense, it is fair to say that Wasserman re-shaped the industry’s architecture to become its “bottleneck.”

2. THE ADVENT OF NEW MEDIA CREATES SPACE FOR NEWCOMERS. The rise of television provided another opportunity for Wasserman. By 1950, 25 percent of American households owned a TV set, and within two years, that penetration rate had doubled. Alongside this, between 1949 and 1953, movie attendance decreased considerably.

Recognizing that television posed new competition, the studios attempted to address this threat in various ways. First, they tried to control TV broadcasting, but the Federal Communications Commission (FCC) blocked moves in this direction. Then, they invested in making the moviegoing experience more unique, introducing enhancements such as CinemaScope and 3-D. Finally, they tried to starve television by not sharing their filmed content with the networks.

In interpreting the opportunities offered by the new technology, studio executives were bound by the traditional “studio logic,” which was based on direct control of distribution and exhibition. In viewing television through this lens, they were trying to get back what the Paramount decree had taken away.

Disillusioned by the failure of their efforts to control the TV industry, the studios became antagonistic toward the medium. This led to a stubborn refusal to provide content. Jack Warner, in particular, famously declared in 1950 that “the only screens which will carry Warner Brothers products will be the screens of motion picture theaters the world over.” In fact, none
Invest in assets at a time when others do not yet perceive them as valuable. And be quick to introduce novel practices when the value of those assets goes up.

of the majors released any of their major works on television until the 1960s.

Hence, most TV programs were produced by New York-based advertising agencies. As these agencies were already producing programs for radio on behalf of clients such as Procter & Gamble, Texaco and Chrysler, they were naturally first in line to translate this ready-made production model to television. But the networks grew restless over their inability to control production and scheduling, so they began exploring alternatives.

Eventually, the president of the NBC network decided it was high time to wrest program control away from advertisers, who would only be allowed to buy time slots for commercial breaks rather than entire programs. Once again, MCA stepped forward, happily willing to offer a complete package for the TV networks, the same way it was doing for the studios by delivering scriptwriters, directors, stars, producers and other talent. Networks, such as NBC, which needed content and could not count on much cooperation from the studios, were all too happy to buy the whole package.

MCA set up a subsidiary, Revue Productions, specifically for television. In a smart move, it changed the commissioning structure: Instead of charging the usual 10 percent on the earnings of its clients, MCA charged a packaging fee of 10 percent of the entire production budget. By charging for the whole rather than each part, MCA was able to leverage its roster of talent much more profitably, because it could now throw in lesser-known actors as part of the overall mix, generating more work opportunities for an ever-expanding pool of talent.

MCA was now, de facto, more of a production company than a talent agency, a metamorphosis that was made complete with the acquisition of Universal in 1962. Though Wasserman ended up dropping the talent-agency side of the business, he kept Universal, which became a leading producer of prime-time TV shows and made-for-television movies. Thanks to the steady stream of revenues coming from its television division, MCA-Universal was able to pour greater investment into feature films, giving rise to yet another industry innovation – the Hollywood blockbuster – epitomized by *Jaws* in 1975, which set the bar for decades to come.

**Reshaping Industry Architecture**

So what can we learn from this story? How did Lew Wasserman manage to reshape the architecture of his industry, and how might we do the same in ours? As is often the case, success depends as much on your own actions as on your competitors’ strategies.

The first lesson is to invest in assets at a time when others do not yet perceive them as valuable. That’s exactly what Wasserman did with the wealth of available talent he saw around him – a ready resource just waiting to be tapped. And when the value of that talent in his possession suddenly soared, he was quick to introduce novel business models to capture more value from those assets.

Still, such actions, by themselves, would not have been enough to secure architectural advantage had it not also been for the actions, or inaction, of the incumbent players, who created additional opportunities for Wasserman. Which begs the question: Why would competitors knowingly create a vacuum, just leaving the path wide open for someone else to step in and fill the void?

When we see industry incumbents failing to seize the obvious opportunities presented by new technology, for example, it’s all too easy to dismiss them as being stupid or shortsighted. But this is unlikely the case. Most research on the movie industry shows that the studios did understand the challenges that both regulatory intervention and the rise of television posed to their industry, and they did set out to address those challenges in their own fashion.

The problem was that their thinking was constrained by the dominant competitive logic
of the day: that the most profitable way of organizing the industry was in vertically integrated firms which controlled exhibition. Indeed, the prolonged success of the studio model up until that time had merely served to reinforce their belief that this was the only way in which a studio could be profitable, so any actions taken were based on this supposed gospel.

When the Paramount decree broke this architecture, the studios focused on less risky segments of the chain, and in so doing, divested assets that did not seem valuable to them any longer. Likewise, they saw in television another opportunity to control, once again, the exhibition of their content – to restore the old order that was safe and familiar to them. Their actions were not, therefore, stupid or short-sighted, but rather, prudent and aimed at reducing business risk in the only way they knew how: by controlling the full value chain. We see some of these same logics being repeated today in a variety of business sectors in attempting to deal with the global economic crisis.

Managers are already familiar with the idea that industries are characterized by different structural features, such as their level of concentration and the existence of barrier to entry, and that these characteristics affect their strategic options. The Wasserman case shows us that there is more to it than that, related to industry architecture. Ask yourself:

- What are the rules and roles that govern your industry, which are affected not only by technological and economic factors, but also by social norms and institutional logics?
- How might new technologies or regulations disrupt or break the rules of the game?
- If you are the industry incumbent, are your actions or reactions unwittingly creating space for newcomers?
- Are there mispriced resources that stand to gain from an environmental shock over which you could potentially acquire control?
- How might you redefine these rules and experiment with new roles that you can play under a new architecture?
- Can you identify novel business models that might help you become the bottleneck of the industry, by leveraging the assets you control?

The emerging architecture that Wasserman introduced was based on full control of one asset and one stage of the chain, as well as on two novel business models that helped everybody in the industry share risk. Through profit sharing, Wasserman made it easier for studios to rely on the services of a smaller number of proven stars without the burden of their cost. With packaging, content-starved TV networks could offer better programming and reduce their dependency on advertising agencies, while enabling Wasserman to use his stable of talent at full capacity. Over time, these practices became the cornerstone of the new institutional logic of the industry.

**Current Architectural Battles Worth Fighting**

I started this article by talking about the music industry, whose fight to control its industry architecture bears more than a passing resemblance to what occurred in the movie industry half a century ago. Indeed, there are currently numerous industries experiencing major technological or regulatory changes, which might provide opportunity for architectural reconfiguration along the lines of what Wasserman succeeded in doing.

The legal battle surrounding the Google Books initiative is another case in point. When, in 2004, Google started digitizing books in partnership with a number of university libraries in the United States, the publishing industry’s first reaction was to try to stop Google from providing free Web access to copyrighted material, so they filed class-action lawsuits in 2005.

A settlement was finally reached at the end of 2008, which enables authors and publishers whose books are still under copyright to be compensated, and creates a revenue-sharing framework that might reshape the publishing industry architecture, with Google having a preeminent seat at the table.

Meanwhile, rival companies such as Microsoft, Amazon, Yahoo and Sony, as well as European governments, have formed an unlikely coalition called the Open Book Alliance. They’re fighting back on antitrust grounds, arguing that Google’s book settlement is the modern equivalent of the 19th century South Improvement Company scheme, when the railroads colluded to fix prices and concentrate power in the hands of John D. Rockefeller.

If Google succeeds, it might be able to leverage its dominant position in Web searches, which hovered around 65-70 percent of U.S.
Opportunities are generated when the dominant logics of the industry, and other regulatory and institutional arrangements, limit the range of options.

market share throughout 2009, to become a central player in the distribution of digital books.

Whatever the outcome, it’s obvious that, thanks to the acquisition of an asset that publishers did not seem to appreciate – out-of-print and public domain books – Google might be able to consolidate a strong position in the industry.

In another field, the digital revolution in the newspaper industry is pushing more newspapers to outsource the production of content. Much creative talent is being “liberated” to work as freelancers. Could these resources that newspapers are letting go be leveraged more profitably by entrepreneurial players under a new industry architecture?

**Insights for Managers**

The Wasserman story highlights two key insights of relevance to managers operating in industries with unstable, contested architectures, and entrepreneurial firms trying to develop architectural advantage in an emerging industry.

First, opportunities for entrepreneurial action are generated, not just by incumbents’ attempts to cope with environmental jolts, but when the dominant logics of the industry, together with other regulatory and institutional arrangements, effectively limit the industry players’ range of options. This creates opportunities for nimble players who are not constrained by the same logics. Furthermore, the actions of the incumbents might actually accelerate the change in architecture by selling assets that the newcomers might leverage more efficiently in the novel architecture they are building.

Second, in designing, championing and institutionalizing innovative business models, the new entrants in a specific segment of an industry can stimulate competition in adjacent segments and consolidate their control over critical resources. This control can be achieved not only through technological design choices, but also from more mundane contractual reconfigurations of the industry’s exchanges.

Thus, merely coming up with an innovative business model is not enough to trigger a change in the architecture of your industry. The acquisition of mispriced resources by newcomers and the incumbents’ (in)action are also critical for newcomers to enter the industry, redraw its boundaries and achieve architectural advantage.

Managers operating in industries with unstable, contested architectures, and entrepreneurial firms trying to develop architectural advantage in an emerging industry, could leverage these insights by asking themselves whether incumbents’ reactions to environmental shocks are creating investment opportunities for them. Venture capitalists trying to identify investment opportunities might examine the role of the overlap between organizational fields, and focus their efforts in industries where more logics intersect, because we would expect more innovative business models to emerge and, therefore, more opportunities to reconfigure the industry and develop an architectural advantage.

* TO KNOW MORE *

