# Why firms make when they can buy? Resource redeployability & firm vertical boundaries

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**Abstract:** Why do firms establish inhouse capacity when transaction costs are low? We argue that insourcing is more attractive when the resources required for inhouse production can be redeployed to alternative uses within the firm. Resource redeployability creates option value and lowers the cost of simultaneously employing internal and external sourcing. We test this argument in U.S. patent prosecution, where firms choose between inhouse and external counsel, and where legal expertise can be redeployed across prosecution and enforcement. Leveraging the Supreme Court's *eBay v. MercExchange* ruling, we show that firms with greater litigation exposure are more likely to establish inhouse capacity, particularly through hiring attorneys rather than agents. These findings extend research on plural sourcing, resource redeployability, and strategic human capital by linking redeployability to vertical boundary choices.

## EXTENDED ABSTRACT

Why do firms "make" when they can easily "buy"? Standard theories of vertical boundaries predict outsourcing when supplier markets are competitive and transaction costs are low, because the market can deliver both efficiency and flexibility without the fixed costs of internal production (Demsetz, 1988; Williamson, 1985). Yet, many firms nonetheless establish in-house capacity while continuing to source externally (Bradach & Eccles, 1989; Jacobides & Billinger, 2006; Parmigiani, 2007; Sørensen *et al.*, 2023). This choice is difficult to reconcile with governance explanations centered on holdup, because the very conditions that limit transactional hazards also make inhouse production appear unnecessary.

Two leading explanations for such make-and-buy strategies, or plural sourcing, relate to knowledge complementarities and flexibility benefits (Chondrakis, Melero, & Sako, 2022; Kapoor, 2013; Krzeminska, Hoetker, & Mellewigt, 2013; Parmigiani & Mitchell, 2009; Puranam, Gulati, & Bhattacharya, 2013). According to these explanations, plural sourcing allows firms to exchange knowledge with suppliers or adjust sourcing arrangements in response to technological change, demand uncertainty, and evolving coordination requirements. However, these perspectives implicitly assume that the benefits of knowledge exchange and flexibility primarily relate to the focal task. As a result, they pay limited attention to how the fungibility of resources used for in-house production, or their redeployability (Giarratana & Santaló, 2020; Levinthal & Wu, 2010; Sakhartov & Folta, 2014), may alter the cost–benefit calculus of inhouse production.

In this paper, we argue that the cost of in-house production is lower – and thus the likelihood of moving from outsourcing to plural sourcing is higher – when the resources necessary to establish in-house production can be redeployed to alternative functions within the firm. When resources are redeployable, investments in internal capacity are less irreversible, because those resources retain value even if in-house production for the focal task proves inefficient or unnecessary. Such redeployability provides distinct benefits to the firm by creating option value: in-house capacity can be repurposed for other internal uses, thereby reducing downside risk and making insourcing a more attractive choice even in competitive supplier markets.

We test this proposition within the context of patent prosecution in the US. This setting offers three key advantages. First, it features well-defined governance boundaries between internal (inhouse counsel) and external (law firm) provision of prosecution services. Second, patent prosecution and patent litigation are distinct activities that nonetheless rely on a shared underlying resource, i.e. patent attorneys, making legal expertise potentially redeployable across tasks within the firm. Third, the setting allows us to leverage the Supreme Court's *eBay v. MercExchange* ruling, which increased uncertainty surrounding enforcement outcomes, weakened the threat of injunctions, and raised the likelihood of facing protracted patent disputes (Chien & Lemley, 2012; Mezzanotti, 2021; Osenga, 2024).

Our analysis shows that firms previously reliant on outsourcing are more likely to establish in-house capacity – by hiring their first patent attorney or agent – when their litigation exposure, measured by the relative incidence of patent suits in their technological area, is higher. Moreover, we find that following the eBay ruling, the likelihood of hiring a first patent attorney or agent increases more for firms with higher litigation exposure. This pattern suggests that firms more likely to be affected by the post-eBay increase in patent disputes and related enforcement work were also more likely to establish in-house prosecution capacity. As a further test of our mechanism, we show that this increase is driven by the hiring of patent attorneys rather than patent agents. Unlike patent agents, patent attorneys have legal training that better allows them to participate in litigation activities, making them redeployable across prosecution and enforcement tasks. Taken together, these results are consistent with the view that firms are more willing to establish in-house capacity when internal resources can be redeployed to alternative uses.

This study contributes to the literature on plural sourcing and firm boundaries. Prior research has conceptualized plural sourcing as a response to knowledge and incentive complementarities, or as a source of flexibility in sourcing arrangements under uncertainty (Bradach, 1997; Chondrakis *et al.*, 2022; Dutta *et al.*, 1995; Parmigiani, 2007; Puranam *et al.*, 2013). We extend this work by showing that the adoption of plural sourcing is also influenced by the redeployability of resources underlying inhouse production. Specifically, we demonstrate that firms are more likely to transition from outsourcing to plural sourcing when investments in inhouse capacity can be redeployed to alternative functions within the firm, thereby reducing the effective cost of simultaneously employing multiple sourcing modes. In doing so, we shift attention from external transaction conditions and task characteristics to the option value of inhouse production, offering a new explanation for why firms "make" even when supplier markets are competitive and transaction costs are low.

This paper also advances the literature on resource redeployability by linking it to vertical boundary choices. Existing research on redeployability has primarily examined diversification, market entry and exit, and portfolio restructuring, emphasizing how firms reallocate resources across products or business units over time (Giarratana & Santaló, 2020; Helfat & Eisenhardt, 2004; Lieberman, Lee, & Folta, 2017; Sakhartov & Folta, 2014; Sohl & Folta, 2021). We show that redeployability similarly shapes firms' decisions about whether to internalize activities, highlighting its relevance for vertical scope. In addition, our study contributes to the strategic human capital literature by demonstrating that firms' make-or-buy decisions depend not only on the availability of talent or mobility frictions, but also on the fungibility of human capital across internal tasks (Coff, 1997; Mawdsley & Somaya, 2015; Starr, Ganco, & Campbell, 2018). Consistent with recent work showing that redeployability affects hiring decisions (Chauvin, Inoue, & Poliquin, 2024; Hietaniemi *et al.*, 2024), we provide evidence that firms are more willing to invest in inhouse capacity when human capital can be redeployed to other firm activities. By linking human capital redeployability to firm boundary decisions, our study bridges research on strategic human capital and the theory of the firm, underscoring how internal labor flexibility reduces irreversibility and alters the economics of insourcing.

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