

**The Importance of Resources in the Internationalization of Professional Service Firms:  
The Good, the Bad and the Ugly**

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We owe a debt of gratitude to seminar participants at the University of Western Ontario, University of California at Riverside, University of North Carolina, Texas Tech University, University of California at Irvine, University of Montana and Texas A&M University for their comments on earlier versions of this work. Also, we thank Paul Beamish, Bert Cannella, Royston Greenwood, Steve Tallman and Laszlo Tihanyi for their comments on earlier versions of this work. An earlier version of this manuscript was published in the *Proceedings of the Academy of Management*.

**November 2005**

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## **Abstract**

We need more knowledge about the bases of internationalization and how the resources used can affect the outcomes of this strategy. Specifically, we examine the importance of valuable firm resources, human capital and relational capital (with corporate clients and with foreign governments), to internationalization and their moderation of the internationalization–firm performance relationship in professional service firms. The results show that human capital and relational capital generally have a positive effect on internationalization (however, relational capital with corporate clients is only positive when teamed with strong human capital). Additionally, we find that human capital positively moderates the relationship between internationalization and firm performance. However, neither form of relational capital moderates the internationalization—firm performance relationship. While relational capital with corporate clients has a strong positive effect on firm performance, relational capital with foreign government clients has a negative effect on firm performance.

Perhaps the most profound business phenomenon of the 20<sup>th</sup> century was the internationalization of large, small, established and new venture firms (Sapienza, Autio, George & Zahra, 2005). Accordingly, the development of multinational enterprises (MNEs) eventually led to changes in the global economy with an increasingly interrelated set of national economies and financial markets. As prominent businesses expanded their operations overseas to satisfy investors' desires for growth and higher performance, the demand for support services in these operations increased. Therefore, professional services firms followed their clients into international markets to service their growing needs (Greenwood & Empson, 2003). In this way, professional service firms facilitated the expansion of the MNEs. Yet, while there is considerable research on the international strategies of large industrial firms, we have less understanding of the internationalization of service firms (Cooper, Greenwood, Hinings & Brown, 1998), particularly the bases for their internationalization. One goal of this research is to fill this gap.

We address the resources needed to internationalize successfully. A significant amount of research on international strategy has produced mixed findings regarding its outcomes (e.g., Lu & Beamish, 2004). While most of the prior research assumes that firms go abroad to exploit strategic assets and take advantage of market imperfections, we know little about the specific assets needed to successfully enter international markets. Given the amount of firms' internationalization across many countries and the desire of others to expand their international scope, we need to better understand the requirements for expanding internationally and how firms can do this successfully. Prior research suggests the motivations for internationalization include economies of scale and scope, increasing market power, knowledge enhancements leading to stronger capabilities and innovation and exploiting entrepreneurial opportunities (Barkema & Vermeulen, 1998; Hitt, Hoskisson & Kim, 1997; Lu & Beamish, 2001; Vermeulen

& Barkema, 2001). Despite these arguments and the underlying research, we have little knowledge of the specific resources on which international expansion is based and how they facilitate the expansion to achieve the aforementioned outcomes (Tallman, 2001).

To examine the internationalization of professional service firms, we study large law firms with home offices in the U.S. These firms entered international markets slowly with the purpose of continuing to serve their U.S. based multinational clients' needs (Spar, 1997). Law firms use human capital to provide services representing intangible products such as information, knowledge and advice related to legal questions (Hitt, Bierman, Shimizu & Kochhar, 2001). And, Spar (1997) argues that law is a business of relationships, particularly with clients. Thus, given that prior work suggests firms enter international markets to exploit their most valuable assets, we examine the effects of law firms' human capital and relational capital on internationalization. Research has suggested that internationalization affects firm performance; to extend our understanding, we examine how the resources of human and relational capital facilitate this effect. The theoretical model is depicted in Figure 1<sup>1</sup>.

Insert Figure 1 about here

This paper contributes to the international management literature by theoretically arguing and showing a direct link between specific and important firm resources and the firm's international strategy. Moreover, we show that the holistic effects of these resources and their interaction produce greater internationalization. While the literature has traditionally focused on resources such as technological know how, we consider resources whose importance to the firm has been recognized in recent management research (Adler & Kwon, 2002; Hitt et al, 2001) and

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<sup>1</sup> While we expect main effects of resources on performance, they are not a part of our theoretical model. Thus, they are not included in the figure. As a check, we tested for a mediating relationship of internationalization between resources and performance. We found none to exist.

that are of particular importance to professional service firms. Furthermore, we argue that these intangible resources moderate the relationship between internationalization strategy and firm performance, thereby extending our knowledge of the resource based view of the firm (RBV). The results support the argument that valuable intangible resources are the most likely to contribute to a competitive advantage and create value for owners. The research especially supports the importance of human capital for internationalization and successful outcomes thereof (*the good*). The research also shows the complexity involved with the effects of relational capital on internationalization and its outcomes (*the ugly*). Relational capital with corporate clients has a positive effect on internationalization only in the presence of strong human capital. Finally, the results show that relational capital with foreign governments has a strong positive effect on internationalization, but a negative effect on firm performance (*the bad*).

We begin with background information on law firms and follow it with specific theoretical arguments and hypotheses. In the following section, we present the theoretical framework for the model in Figure 1. We then describe our methods and present the results. The theoretical and practical implications of the results are discussed in the final section of the paper.

### **Background and Theoretical Framework**

The increasing internationalization of major businesses led professional service firms such as management consulting and law firms to adjust to the new environment (O’Conner, 1996). Particularly, the growing interrelationship among national economies and the development of the international financial markets heightened the importance of law on a global basis and thus changed the landscape for law firms (Silver, 2001). Indeed, globalization has led to the creation of something akin to “global economic law” (Slaughter, 2002; Dezaly & Garth, 2002). According to Silver (2001) and Spar (1997), however, only a few large U.S. law firms

moved into international markets in the early years of globalization. And, most of them only moved into these markets to service their existing multinational clients. They serviced these clients by continuing to advise them on U.S. law (e.g., how their international contracts fit the legal standards in the U.S., implications of U.S. tax regulations, etc). They used expatriates to staff the offices, generally including an expatriate partner to oversee the local foreign office operations and maintain effective relations with long-term multinational clients (Silver, 2005).

After entering these markets, the growth of the global economy and the reduction of regulatory limits on foreign firms practicing local law encouraged large U.S. law firms (and firms based in other countries such as the U.K.) to expand their international operations (Silver, 2001). The law firms that entered international markets early were usually in the best position to take advantage of such regulatory changes. The regulatory changes allowed them to hire (or partner with) attorneys who held local law degrees and licenses in order to practice local law. Indeed, the best firms often hired individuals who held local law degrees and licenses as well as specialized graduate training (LLM degrees) from top U.S. law schools. At times, they employed these people in their U.S. offices after receipt of their graduate law degrees from the U.S. law school. After they learned the law firm's culture, general practices and internal routines (Winter, 2005), most were transferred to the firm's local office in their home country.

Supported by technological advances (IT), privatization processes (Zahra, Ireland, Gutierrez & Hitt, 2000), and the opening of national markets, substantial growth in international business activity was experienced in the 1990s. Likewise, the international expansion of professional service firms reached unprecedented levels during this period. Silver (2000) suggested that the 'elite' law firm in the current competitive landscape emphasizes its internationalization. As we argue below, the law firms with the strongest human capital and

relational capital were better able to take advantage of the opportunities available in international markets. That is, they used their often idiosyncratic intangible resources to expand existing international operations and to enter new international markets (Barney & Arikan, 2001).

### **Resources as a Base for Internationalization**

To be successful, firms must have the appropriate resources for international expansion. However, possessing valuable, rare and inimitable resources is a necessary but insufficient condition to achieve a competitive advantage. Those valuable resources also must be managed effectively (bundled and leveraged) to achieve a competitive advantage (Barney & Arikan, 2001; Sirmon, Hitt & Ireland, 2006), especially in international markets.

The primary asset providing a base for professional service delivery is knowledge (Greenwood & Empson, 2003; Grosse, 2000; Maister, 1993). In a professional service firm, knowledge (especially tacit knowledge) largely resides in the partners and associates (Bartlett & Ghoshal, 2002). As a result, professional service firms create value through their selection, development and use of human capital (Lepak & Snell, 1999; Hitt et al, 2001). Knowledge in law firms is based on expertise (legal training and education) and experience (both general experience in the practice of law and firm-specific experience) (Spar, 1997). Teams of partners and associates use their expertise and experience to customize the services to each client. Thus, law firms and other professional service firms have what are often referred to as ‘walking assets’—human capital (Spar, 1997).

In addition to quality legal training and education, Partners’ experience can be especially helpful in international markets. Silver (2000) suggests that law firms’ involvement in large and complex corporate and financial transactions enable the partners with such experience to export and adapt that knowledge to local legal systems in international markets. She argues that, “...

this experience enables U.S. lawyers to advise even when U.S. law does not govern, because their advice goes to the strategic use of law in business relations” (Silver, 2000, p. 1096).

Partners in professional service firms also perform a managerial role. Thus, managerial competences in such areas as recruiting, leading project teams, and retention of personnel as well as strategic management skills are required for partners (Løwendahl, 2000). Some of these activities are increasingly handled by professional administrators for law firms (Cooper, Hinings, Greenwood & Brown, 1996), but the managing partners still maintain the CEO roles and partners manage the client projects and lawyers assigned to them (Spruill, 2001). Firms can exploit these leadership and managerial skills over time through expansion into new markets (e.g., international) (Mahoney & Pandian, 1992; Wernerfelt, 1984). Experience helps managers to develop knowledge of the opportunities for expansion into new international markets as well as knowledge of how to manage relationships and operations in the new environment (Manolova, Brush, Edelman & Greene, 2002; Westhead, Wright & Ucbasaran, 2001). In support of this argument, Sapienza et al, (2005) argue that managerial competence plays an important role in internationalization. Based on their experience, managers establish routines (e.g., for internal processes and external relationships) that facilitate the establishment and operation of new offices. For this reason, managerial competences are more fungible across country borders than some professional skills. And, it has been common for law firms to move a partner from the home operations to manage a new office established in international markets (Spar, 1997) because of the importance of effectively serving their long-standing corporate clients. Additionally, the firm’s reputation and the associated trust in specific partners by clients are likely to serve as more important resources for professional service firms than their specialty



expertise (Cooper, Rose, Greenwood & Hinings, 2000; Grosse, 2000), especially in generating demand for the firm's services from customers in foreign countries.

The top ranked institutions from which lawyers with the best formal education receive their degrees often have international reputations and educate many people from outside the United States. Data suggest that some of the foreign lawyers hired by large U.S. law firms for their international offices have a specialized graduate degree from one of the top U.S. law schools. These foreign lawyers are attracted to work for the firms that have strong human capital and the best reputations with major clients (Silver, 2001; Spar, 1997). Thus, law firms with strong human capital exploit that resource by capturing the opportunities for internationalization and developing necessary personnel for internationalization (Løwendahl, 2000). Clients choose firms with the strongest human capital to service their needs, especially the complex needs that they have in international markets. These arguments suggest that professional service firms with the strongest human capital are the most likely to expand into international markets and to have the largest international scope of operations, leading to the following hypothesis.

***Hypothesis 1: There is a positive relationship between a firm's human capital and its level of internationalization.***

The capability to build an effective working relationship with clients is one of the most important assets held by professional service firms (Cooper et al, 2000). Relational capital refers to the joint benefits embedded in the relationship between two or more parties that is highly important to those parties (Dyer & Singh, 1998). Relational capital includes the knowledge and understanding of the other party leading to shared meaning, commitment and norms of reciprocity (Granovetter, 2005; Zucker & Darby, 2005).

As judges of the potential value provided, clients select from among the alternative service providers (Priem, 2006), choosing those who provide them the most value (Sirmon et al,

2006). As such, professional service firms must be responsive to clients and provide services that satisfy their needs (Griffith & Harvey, 2004). These firms use their knowledge to satisfy clients' needs transferring some of this knowledge in the process (Nodofofor & Levitas, 2004). To buffer against a client's use of the knowledge in opportunistic ways, the service providers try to build a long-term relationship. The continuity of the relationship and the amount a client is willing to pay for services reflect the quality of the relationship between the client and provider (Saparito, Chen & Sapienza, 2004).

Relational capital is generally assumed to be composed of three components: trust, information transfer and joint problem solving (Uzzi, 1997). Relational capital exists when the relationship becomes embedded and thus exhibits these three dimensions. The three components are interrelated in that trust often leads to significant information sharing which in turn produces knowledge about the partner and thus allows more joint problem solving (Yli-Renko, Autio & Tontti, 2002). The development of norms of reciprocity leads to trust in the relationship (Putnam, 2001).

As the parties interact over time, they build understanding of each other through the sharing of information and thus have shared meanings in the relationship. Law firms' knowledge of their clients' business, industry and idiosyncratic policies and practices allows them to 'customize' their service for the client. The greater the knowledge of the other party, the greater one's partner-specific absorptive capacity for continued learning. Absorptive capacity is the ability to acquire knowledge, assimilate it and use it towards commercial ends, but it is bounded by prior knowledge (Cohen & Levinthal, 1990). A larger partner-specific absorptive capacity often translates into greater relational capital (Dyer & Singh, 1998). The trust and information sharing components are usually affected by the volume of exchanges and the length of time the

relationship has existed between the parties (Dyer & Singh, 1998). That is, repeated exchange allows service firms to develop client-specific capabilities. These capabilities, in turn, enhance the quality of the services provided to the client while simultaneously reducing the costs of providing those services (Ethiraj, Kale, Krishnan & Singh, 2005). Customized service is based on and leads to further joint problem solving between the firm and its client. Thus, customized quality service based on idiosyncratic knowledge is valuable, rare and difficult to imitate, thereby providing the professional service firm a competitive advantage (Dyer & Singh, 1998). Additionally, longer relationships tend to afford stability and continuity that contribute to norms of reciprocity and trust, which in turn generate referrals and endorsements (Nahapiet & Ghoshal, 1998). Accumulated experience with a particular partner also helps service firms to extend their knowledge base that is instrumental in obtaining new clients.

Two types of clients can be especially important for international expansion by professional service firms, large corporations and foreign governments. As noted earlier, initial forays into international markets by many large law firms were intended for the purpose of servicing large corporations among their current clients (joint problem solving) (Silver 2001; Spar, 1997). Professional service firms' relationships with large corporate clients can be highly valuable. Professional service firms can access their large corporate clients' knowledge of foreign markets and their global reputations (information sharing) (Ellis, 2000; Tsai & Ghoshal, 1998). The clients provide legitimacy to their service providers that enter new international markets helping them to overcome liabilities of foreignness, especially if they seek to expand their client base in that market (Dess, Gupta, Hennert & Hill, 1995). These relationships may also allow the service provider to form relationships with other important entities in the new markets such as government units (and officials) and suppliers. Further, law firms can utilize

their client-specific capabilities more effectively by expanding their services provided for this particular client, for instance by serving this client abroad.

Foreign government clients can also facilitate international expansion of professional service firms. Providing services to foreign governments in the provider's home country helps the firm to learn more about the client's country, culture and market opportunities abroad (information transfer) and can strengthen the firm's reputation especially in the home markets of the governments represented (Ellis, 2000). A satisfied foreign government client can facilitate entry by providing the necessary contacts and helping the service provider gain the knowledge necessary to enter and operate effectively in the client's home country (joint problem solving). Relationships with a foreign government may be especially important for law firms because of the government regulations or legal obstacles to entering the market (Griffith & Harvey, 2004). The relationship with foreign governments usually occurs through a contract in which the law firm represents the government in a special legal matter in the U.S. To represent the government client effectively requires the law firm to make client-specific investments to learn the government's needs and idiosyncratic characteristics (e.g., culture and home legal system) thereby enriching the relational capital. Dyer and Singh (1998) refer to this knowledge as a relationship-specific asset. This knowledge alone can facilitate the law firm's entry into the government's home country market. Larger contracts in dollar value and contracts covering longer periods signify the foreign government's comfort with the law firm (positive relationship—development of trust). Additionally, experience and relationships with particular foreign governments allow the law firm to develop generalizable knowledge to deal with different regulatory and cultural environments.

Prior research has found that firms are more likely to enter a market after the entry into that market by a current or potential customer (Martin, Swaminathan & Mitchell, 1998).

Additionally, other research has shown that foreign market opportunities are often identified through social ties (Ellis, 2000). Therefore, we should expect relational capital with multinational clients and foreign governments to lead to international market entry and expansion. These arguments lead to the following hypotheses.

***Hypothesis 2a: There is a positive relationship between a firm's relational capital with large corporate clients and its level of internationalization.***

***Hypothesis 2b: There is a positive relationship between a firm's relational capital with foreign government clients and its level of internationalization.***

Human capital and relational capital are independent constructs, but they also have complementary qualities. In fact, Burt (1997) suggests that relational capital is a contextual complement to human capital. Firms' relational capital enhances the value of their human capital for international expansion, while human capital allows firms to exploit their relational capital more effectively. As clients, especially multinational corporations and foreign governments, share information with a law firm, the absorptive capacity associated with its human capital facilitates the learning required to identify opportunities in foreign markets based on this information (Sapienza et al, 2005). The firm's relational capital provides access to clients and other contacts in international markets from which the firm's human capital can learn. As the human capital grows with the knowledge acquired about new international markets and about servicing the firm's clients in these international markets, the firm builds capabilities to expand its existing international operations and enter other international markets successfully. Furthermore, relationships with large corporate clients and foreign governments often enhance the firms' ability to attract new lawyers to service existing corporate clients or new local clients in international markets. Major clients (e.g., large and respected multinational corporations and

foreign governments) can provide legitimacy to the expertise of a firm's human capital (Bapuji & Crossan, 2005). Such legitimacy helps firms obtain new clients and new lawyers in the foreign markets entered. However, the managerial expertise associated with the human capital of the firm leads to better selection and more effective integration of new hires.

From a different perspective, professional service firms having strong relational capital with multinational corporate clients may desire to enter international markets, but the corporate client is unlikely to employ them in foreign markets unless they have strong human capital. Interpretation of U.S. law in foreign contexts is likely to be more complex and challenging than in a domestic context. Thus clients need more sophisticated advice and counsel on U.S. law as it applies in a foreign context. Also, as noted earlier, firms with relational capital have special knowledge of their partners; yet they must have strong human capital to exploit this knowledge in serving their clients in foreign markets. Therefore, firms with lower levels of human capital may have a low probability of entering an international market using the client as a primary source, even when they have strong relational capital (with multinational corporations or foreign firms).

Firms bundle resources to create capabilities (Sirmon et al, 2006). To enhance their capability to operate in international markets successfully, professional service firms can integrate their human capital and relational capital given they are complementary (Adler & Kwon, 2002). Together these arguments suggest an interactive (complementary) relationship between human capital and relational capital on internationalization, leading to the following hypotheses.

***Hypothesis 3a: Human capital and relational capital with large corporate clients have a positive interaction effect on a firm's level of internationalization.***

***Hypothesis 3b: Human capital and relational capital with foreign government clients have a positive interaction effect on a firm's level of internationalization.***

## **Resources, International Strategy and Firm Performance**

The primary purpose of a strategy is to enhance the firm's performance and therefore a firm's international strategy should affect its performance. Above we argue that a firm's resources drive its strategy as suggested by the RBV. In turn, we expect internationalization based on valuable resources to affect firm performance as shown in Figure 1.

If firms realize the benefits of internationalization as expected, the strategy should lead to higher firm performance. In support of this conclusion, early research in international business largely argued for a positive relationship between internationalization and firm performance. However, the empirical research on the relationship between these two constructs has produced mixed results (for recent reviews see Goerzen & Beamish, 2003; Tallman, 2001). In fact, later research suggests that the relationship between international diversification and performance is curvilinear, resembling an inverted U-shape (Hitt, Hoskisson & Kim, 1997). While early actions to expand internationally have positive effects on firm performance, at some point, the diversity of that expansion creates substantial complexity and is difficult to manage, exceeding the firm's capabilities. Thus, further expansion produces lower firm performance. This overall relationship has largely been demonstrated by Lu and Beamish (2004) studying a large sample of Japanese industrial firms longitudinally over a 12-year period. The results of the research suggest that at intermediate levels of internationalization, we should expect a positive effect of this diversity on firm performance. Managers in the firm have had time to learn how to enter and operate effectively in international markets. As such, they know how to overcome the costs of operating in foreign environments and achieve the benefits they afford (Goerzen & Beamish, 2003). Additionally, they have not exceeded the firm's capabilities to manage the international expansion.

Service firms, especially some professional service firms, may differ from industrial firms in that their products may be universally applicable (e.g., management consulting). While legal knowledge is not necessarily applicable across boundaries, the legal services extended in early internationalization of the U.S. law firms studied involved an application of U.S. law to legal questions encountered by their large multinational clients. Thus, these firms were servicing their current clients and applying their current legal knowledge. As a result, they did not experience significant liabilities of foreignness in their early entry into international markets. Additionally, unlike many other industries, these firms entered international markets slowly. Many of the firms only entered those markets where they were requested by their multinational clients and then expanded their services and client base slowly (Spar, 1997). While some firms entered international markets early, most started entering international markets in the late 1980s and accelerated their expansion in the 1990s. Furthermore, because of regulatory restrictions, they could not practice local law until countries began opening their local markets for legal services to foreign firms in the 1990s. As a result of the evolutionary expansion into these markets, they were more successful than the typical firm entering international markets. They used their current knowledge with existing clients and therefore their learning curve for entry into these markets was much shorter. By the time that they were allowed to expand into the practice of local law, they had developed knowledge of the culture and markets as well as built local relational capital resulting in more successful expansion. Furthermore, most of these firms have an intermediate level of internationalization. Based on these arguments we expect internationalization of law firms to be positively related to performance. The preceding arguments lead to the following hypothesis.

***Hypothesis 4: There is a positive relationship between internationalization and firm performance.***



While a positive relationship between internationalization and performance is expected, the success of internationalization efforts is likely to be affected by the level of resources it can deploy in these efforts. Firms are motivated to enter international markets in order to leverage their human and relational capital as argued earlier. Yet, firms are motivated to enter international markets for other reasons as well. For example, some firms may observe the industry leader entering international markets and follow its lead (i.e., imitate the strategy). Yet, imitation can only achieve a measure of success if the firm has the appropriate resources. If it has a lower level of human or relational capital, for example, it is unlikely to achieve the success of the industry leader and may even fail. In this case, it will not have adequate resources to overcome the liability of foreignness (Zaheer, 1995). With lower levels of human capital, the MNEs in those markets are less likely to use them to provide legal advice on their activities. It will also be more difficult to obtain new clients, given that human capital is a major concern for clients of professional service firms.

Firms experiencing less success in their domestic market may also be motivated to enter new markets. We know from prior research that such firms often take higher risks in an attempt to enhance their competitiveness (Morrow, Sirmon, Hitt & Holcomb, 2005). Yet, these firms are likely to be resource deficient or are unable to leverage the resources that they hold. Otherwise, they would be more successful in their domestic market. Therefore, with resource deficiencies, management deficiencies, or both, they are unlikely to be successful in international markets where the challenges are even greater. Internationalization places substantial requirements on managers; firms with stronger human capital, as discussed above, should be better able to organize the international expansion and facilitate coordination between home and host country offices, thus exploiting internationalization advantages more effectively.

If firms move into international markets without adequate human capital, they may not be able to provide the level of service that their clients expect. In such cases they are likely to lose existing clients. Alternatively, if they enter international markets without adequate relational capital, they may experience problems in obtaining enough clientele to achieve positive returns in the foreign office (liability of foreignness—Zaheer, 1995). Adequate numbers of multinational corporate clients afford instant business in the new market and legitimacy to obtain more business locally. However, without it, the firm must establish new relationships and build a new client base. Building a new client base takes time, is costly and generally produces lower returns until it is built. Additionally, institutional barriers to entering new foreign markets and to building successful ventures may exist. However, foreign government clients can facilitate entry into a new market and building a successful business by helping the firm to overcome (deal with) these institutional barriers. For example, they can help with contacts to learn the nuances of the regulatory policies and they also provide their own form of legitimacy. Having little or no relational capital with the government in the foreign market, new entrants may encounter difficulties obtaining timely government approval to operate in the foreign office; it must begin anew to establish relational capital. Building such capital requires investment in relationship-specific assets and thus requires time and devoted efforts (Dyer & Singh, 1998). Until such capital exists, transaction costs tend to be high and relational efforts are relatively easy to imitate by competitors. Thus, firms with less relational capital entering new international markets probably experience problems in establishing a competitive advantage. In such cases, the firms are likely to experience lower returns.

Moreover, relational capital increases the potential to learn from clients. Repeated interaction with clients helps the service provider to identify useful knowledge held by clients

and where this knowledge is located (Kale, Singh & Perlmutter, 2000). Client-specific absorptive capacity may even allow the provider to tap into clients' tacit knowledge. Thus a law firm may learn from its clients, particularly those with much international experience, how to more efficiently operate in international markets. These arguments suggest that resources, in this case human capital and relational capital, positively moderate the relationship between internationalization and firm performance. In other words, strong human capital and high relational capital each increase the positive effect of internationalization on firm performance. These arguments lead to the following hypotheses.

***Hypothesis 5a: Human capital positively moderates the relationship between internationalization and firm performance.***

***Hypothesis 5b: Relational capital with large corporate clients positively moderates the relationship between internationalization and firm performance.***

***Hypothesis 5c: Relational capital with foreign government clients positively moderates the relationship between internationalization and firm performance.***

## METHODS

### Sample

Relationships between firm resources and strategy vary by industry as the critical resources tend to vary; thus a single-industry sample to test the hypotheses is desirable (Dess, Ireland & Hitt, 1990). We chose law firms because their critical resources are human capital and relational capital similar to most professional service firms (Hitt et al, 2001). Moreover, law firms are particularly relevant for this study because in the 1990s they made significant investments in international expansion as a major source of growth (Scannell, 2002). The sample for this study was drawn from the list of the 100 largest law firms by total revenue in the U.S. published annually by the *American Lawyer*. We measured resources, strategies, and performance of these firms for 1992-1999. Because of acquisitions and consolidations as well as

changes in the ranking, we have data for 72 law firms over this period. Further, based on the lag structure used and some missing data, the total number of the firm-year observations is 412. The sample statistics are shown in Table 1.

Insert Table 1 about here

### **Analytical Approach**

The data are both cross-sectional (firms) and time series (years) in nature, thus a panel data methodology was chosen. We used the least squares dummy variable (LSDV) model involving a generalized least squares estimation, using dummy variables for each firm and each year instead of a common intercept for all observations (Hsiao, 1986; Sayrs, 1989). The dummy variables help control for unobserved firm-specific and year-specific heterogeneity (Bergh, 1993). The LSDV model also minimizes problems of heteroscedasticity and autocorrelation, both of which can be caused by unaccounted firm-specific heterogeneity (Goodstein & Boeker, 1991; Sayrs, 1989). Further, we incorporate a one-year lag between dependent variable and independent variables because their effects will likely not be immediate (Goodstein & Boeker, 1991). Thus, values for the dependent variables cover 1993-1999 and for the independent variables 1992-1998.

### **Dependent and Independent Variables**

Hypotheses 1-3 predict relationships with internationalization as the dependent variable, while hypotheses 4-5 propose relationships with internationalization as independent variable and firm performance as dependent variable. The sources and measurement of these and other variables are explained below.

**Firm performance.** We adopted the measure of law firm performance used by Hitt et al (2001). Firm performance was operationalized as the ratio of worldwide net income to total firm

revenue. The data were derived from the profitability index reported annually by the *American Lawyer*, referred to as the API. API is the ratio of profits per partner to revenue per lawyer (Brill, 1987: 16).<sup>2</sup> We removed the number of partners from the numerator and number of lawyers from the denominator; the resulting measure may be interpreted as return on sales. The ROS is a preferred performance indicator in internationalization research and correlates highly with other indicators of profitability, such as the ROA (Lu & Beamish, 2001).

**Internationalization.** Most common measures of internationalization are unidimensional, such as foreign sales as a proportion of total sales. However, unidimensional measures have various problems including failure to reflect the breadth (e.g., number of foreign countries) and depth of internationalization (e.g., degree of commitment to each country) simultaneously (Hitt et al, 1997). More recent research assessing the relationship between international expansion and firm performance uses a multidimensional approach (e.g., Lu & Beamish, 2004). In our study, the degree of internationalization of each law firm in each year is measured by an entropy measure based on the number of foreign offices and the number of lawyers in each office. The measure considers both the number of foreign markets in which the firm operates as well as the relative importance of these markets to the firm (based on the number of lawyers) (Goerzen & Beamish, 2003; Hitt et al, 1997).<sup>3</sup> These data were also obtained from the *American Lawyer*.

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<sup>2</sup> These data are self reported and unaudited. We recognize the potential for bias in any self-reported data. That said, much secondary data used in strategic management research are self reported. We discussed this concern with officials at the *American Lawyer* and they responded that they monitor the reported figures carefully and verify them with a source (usually a current or recently retired partner) at each firm. They compare the data received with several sister publications and have a good knowledge of the general billing rates and headcounts of each firm. They request explanations for any figures that are questionable. They also suggested that competitors monitor the data and express concern if a law firm's data appear to be odd (officials at *the American Lawyer* then ask for justification of the questioned figures).

<sup>3</sup> The number of lawyers in each office was used as a proxy for the revenue provided by that office. Revenue data were unavailable. Lawyers are the primary providers of the professional services and thus the generators of revenue. There is a high correlation between the total number of lawyers employed by a firm and its total annual revenues

**Human capital.** Our measure of human capital is similar to that used in Hitt et al (2001) but has an additional component. This measure has three components, quality of law school attended by partners (a proxy for articulable knowledge and prestige), average experience of the partners in the focal firm (proxies for tacit and firm-specific knowledge, e.g., of clients), and total partner experience in the legal field averaged across partners for the focal firm (a proxy for tacit legal and managerial knowledge that may be fungible). Data on all law firm partners were obtained from the *Lawyers Almanac*, which identifies all partners per firm and the law schools from which they obtained their degree. Quality of the law school was evaluated based on the ranking provided by the *Gourman Report* because of its comprehensiveness and high correlation with similar but more limited rankings. As a validity check, Hitt et al (2001) calculated Spearman rank-order correlations between the *Gourman Report* rankings and the top 25 law schools ranked by the *U.S. News and World Report* of .85. Additionally, they found that the rankings of the top 25 law schools based on compensation of graduates had a rank-order correlation with the *Gourman Report* rankings of .64. We calculated an average ranking score for each firm, using data from 1991 (the immediate year previous to the beginning year of our data) for each firm.

We used a survey to obtain data on total firm-specific experience of partners and total partner experience for each firm, because no secondary data are available on these variables. During the year 2000, we contacted 12,217 partners via electronic mail and received 2,701 usable responses for an effective response rate of 22.1 percent. To control for potential non-response bias, we built a ratio of responding partners to total partners per firm. We correlated this value with the performance data for the firms and found no systematic relationship ( $r = .08$ ,  $p <$

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suggesting that the number of lawyers in an office is a good proxy for its revenue generation. Prior research has found a high correlation between number of employees and the firm's sales revenues (Hitt, Hoskisson, Johnson & Moesel, 1996).

.5), limiting concerns for non-response bias. Furthermore, we found firm-specific experience and total partner experience to exhibit statistically significant positive correlations with total general experience in the legal field ( $r = .30$  and  $.26$  respectively,  $p < .05$ ) (secondary data based on the date of receipt of law degree) providing support for the efficacy of this measure.

Based on these data we calculated the average firm-specific experience and partner experience for each law firm in our sample. We then adjusted these values backwards year by year for each firm consistent with the time frame of other data (1999-1992). To make this adjustment, we considered the average percentage of partners leaving each firm for retirement and other reasons based on data available from the *Lawyers Almanac*. The measures of the three components of human capital were factor analyzed and loaded on one factor (eigenvalue = 2.07; Cronbach's alpha = .75). Thus, we created a composite measure of human capital based on standardized factor scores. The score created by the factor analysis has a mean of 0 and a standard deviation of 1 (*STATA Reference*, 1999).

**Relational capital.** We focus on a major type of relational capital for professional service firms, their relations with clients. Established relationships with major clients are considered a critical resource to professional service firms (Cooper et al, 2000). Large clients afford legitimacy to a firm through their reputation, particularly in a new market (Burt, 1992). A client can provide referrals or introduce new clients to the law firm and also can provide information on the market. Thus, large clients can be especially beneficial to law firms entering international markets (Burt, 1992). Because large corporations and foreign governments are major clients yet different in orientation, we developed two associated measures, "relational capital with corporate clients" and "relational capital with foreign government clients."

For the former, we identified major corporate clients from the 250 largest U.S. corporations for each of the law firms in our sample in each year (identified as the most

important corporate clients from *The National Law Journal*). For each law firm and year we counted the number of these large corporations that were clients. The average number of clients was 4.6 with a standard deviation of 4.7. Only one of the law firms in our sample did not serve any of these clients. We also calculated the total percentage of these clients' sales that resulted from their foreign operations to reflect the value of these relationships for entry into foreign markets (indicates the potential international network to which law firms might have access). The data to calculate the ratio of international to total sales for each corporation in each relevant year were obtained from COMPUSTAT. Further, we examined the length of time the law firm had a relationship with each client as a proxy for trust, an important component of relational capital (Adler & Kwon, 2002). Previous research suggests that, "interfirm trust is incrementally built as firms repeatedly interact" (Gulati, 1995: 92). As noted in the theory section, trust promotes greater information sharing. Such sharing increases knowledge of the partner and allows customized service. Developing and implementing customized service requires joint problem solving between the professional service firm and the client. An indicator of repeated interactions is shown by a corporation retaining a law firm continuously over time. Thus, analogous to Gulati (1995), if law firm A served corporation X in 1992, 1993, and 1994, our indicator variable for repeated interactions for this law firm would be 0 in 1992, 1 in 1993, and 2 in 1994. However, because the marginal increase in trust is likely to decline over time, we log-transformed these values and then aggregated them for each law firm – year observation. This approach produced three components for this relational capital measure—number of large corporate clients, international diversity of these clients, and the continuity of the relationship. The internal reliability of this variable was well above recommended levels (Cronbach's alpha = .91). These three measures were factor analyzed and loaded on one factor (eigenvalue = 2.54);



standardized scores were used to construct the measure of *relational capital with corporate clients*.

The measure for *relational capital with foreign government clients* is also multidimensional and derived in a similar manner. The 1938 Foreign Agents Registration Act (FARA) requires U.S. law firms to report all legal representation of foreign governments in the U.S. to the U.S. Department of Justice. These reports are available, except for the years 1992 – 1994. For the missing years, we used averages from the previous four years. First, we created a variable that indicates the number of foreign governments as clients for each law firm in each year. Second, we created a variable containing the total yearly compensation received from these governments to reflect the extent of the interaction between law firm and client and thus the goodwill created. When a government is willing to pay higher compensation for services, it indicates a level of trust in the law firm. Because the precise compensation was not listed for about ten percent of cases, we used the average of the other cases in this year as an estimate of these values. Third, we created a variable indicating the length of time in consecutive years that the government was a client for a firm (repeated interactions). The internal reliability among these three indicators was well above the recommended levels (Cronbach's alpha = .89). These three components were factor analyzed and loaded on one factor (eigenvalue = 2.46). The standardized factor scores were then used to construct the variable *relational capital with foreign government clients*.

The single factors for each type of relational capital reflect the expected strong interrelationships among the three components of such capital. We factor analyzed the two relational capital measures and they loaded on two independent factors as expected. Thus, the two measures were maintained as separate independent variables.

## Control Variables

We included six additional variables to control for their potential effects on internationalization and firm performance (the dependent variables). Large law firms with many partners may find it easier to expand internationally because of potential slack human resources that can be allocated to international offices. In contrast, when the *size* of the law firm is small, the firm may not be able to expand internationally even if the firm has high quality human capital because the limited number of partners serves as a constraint. More generally, the size of the firm reflects its resource portfolio or capacity for international expansion. Accordingly, firm size measured by the number of partners in each firm was included to control the effects on internationalization and performance.

Most work in professional service firms is accomplished using teams of professionals (several associates with partners as the team leaders and primary contacts with the client). This relationship represents the structure of the primary human capital in these firms and is commonly referred to as the firm's *leverage* (Samuelson & Jaffe, 1990). Leverage is defined as the total number of associates in the firm divided by the total number of partners (Sherer, 1995) and has been shown to affect firm performance (Hitt et al, 2001). Data for this measure were obtained from the *American Lawyer*.

Location in *New York City* was used as a control for several reasons. Importantly, firms located in NYC have access to resources that facilitate international expansion (e.g., investment banking community, United Nations, concentration of global commercial banks, etc.). Additionally, most of the firms that have a specialty in international law have locations in NYC. Thus, this variable controls for the potential effects of these advantages on internationalization and outcomes thereof. The source for these data was the *American Lawyer*.

Prior research suggests that the degree of *service diversification* and of *domestic geographic dispersion* can influence firm performance (e.g., Hitt et al, 2001). Measures for service diversification and geographic dispersion in each year were calculated with a Herfindahl index (Sherer, 1995). Data were obtained from the *Lawyers Almanac*. The data from the various law journals used in our analysis are self-reported by the law firms.

Finally, we controlled for the potential effects of *prior performance* on the tendency to expand internationally because performance can influence the choice of strategy (Hitt, Boyd & Li, 2004). Thus, we included firm performance for time period t. We also conducted a split sample analysis for high performing and low performing firms in 1992 and projected the trend of internationalization through 1999. There appear to be no differences in the internationalization of low performing and high performing firms (the results of the split sample analyses are available from the authors).

## RESULTS

The descriptive statistics and intercorrelation matrix are presented in Table 2. We used general least square regression analysis (GLS) to test the hypotheses. The GLS approach does not allow calculations of variance inflation factors (VIF). Using an ordinary least square regression (which is more conservative than the GLS for VIFs because it does not control the firm and year), the VIFs (and modest correlations between the independent variables) suggest that multicollinearity problems are unlikely (highest VIF is 4.8, well below the benchmark of 10). We took additional actions to avoid problems with multicollinearity by centering the variables used to test the predicted interactions (Aiken & West, 1991).

Insert Table 2 about here

The results for testing hypotheses 1-3 are presented in Table 3. Hypothesis 1 suggested a positive relationship between human capital and internationalization. As shown in table 3, the coefficient for human capital is positive and marginally statistically significant ( $p < .058$ ). Thus, the results provide some support for hypothesis 1.

Hypothesis 2a stated that there is a positive relationship between relational capital with corporate clients and internationalization. Hypothesis 2b suggested a positive relationship between relational capital with foreign government clients and internationalization. As shown in Table 2, the coefficient for relational capital with corporate clients is marginally statistically significant and negative ( $p < .065$ ), providing no support for hypothesis 2a. However, the coefficient for relational capital with foreign governments is positive and statistically significant thereby supporting hypothesis 2b.

Hypothesis 3a suggests that a positive interaction effect exists between relational capital with corporate clients and human capital on internationalization. Likewise, hypothesis 3b states that relational capital with foreign government client and human capital interact to have a positive effect on internationalization. The results presented in Table 3 show a positive and statistically significant coefficient for both interaction effects. These results support hypotheses 3a and 3b.

To examine these interaction effects further we graphed the results using a method from Stewart and Barrick (2000) (see Figure 2). In the graphs presented in the figure, we show the effects on internationalization for two levels of each type of relational capital, low--minus one standard deviation from the mean and high--plus one standard deviation from the mean. We then plotted internationalization regressed on different levels of human capital. As shown in Figure 2, the highest level of internationalization is achieved when both human capital and relational

capital with corporate clients are high. The second graph in Figure 2 also shows that the highest level of internationalization is achieved when both human capital and relational capital with foreign government clients are high. Internationalization is higher at all points when relational capital with foreign government clients is high compared to when it is low, regardless of the level of human capital.

Insert Table 3 and Figure 2 about here

The decision to engage in a strategic action (e.g., internationalization) may be affected by unobserved factors thereby introducing potential bias due to endogeneity. To avoid misspecification because of unobserved factors, we employed a two-stage Heckman (1979) procedure to examine the effects of internationalization on firm performance. This procedure calculates a control variable in stage one (in this case we dummy coded internationalization and used it as the dependent variable in a probit model) called the inverse mills ratio that is then inserted into the stage-two model (in our case, the model with performance as the dependent variable). The inverse mills ratio removes any potential bias due to endogeneity and sample selection (Shaver, 1998). Following the Heckman procedure, NYC location and prior performance were entered in the first-stage model but not in the second-stage model.

The results of the stage-two model used to test hypotheses 4 and 5 are presented in Table 4. Hypothesis 4 suggests that internationalization has a positive effect on firm performance. Table 4 shows a positive and statistically significant coefficient for internationalization, providing support for the hypothesis. Because of past research we also tested for a curvilinear effect of internationalization on firm performance. Interestingly, the squared term was negative and statistically significant. Therefore, relationship resembles the inverted U-shape found by previous researchers. Additionally, while not hypothesized, the results in Table 4 also show that

human capital and relational capital with corporate clients have statistically significant and positive main effects on firm performance. However, relational capital with foreign government clients unexpectedly has a statistically significant negative effect on performance.

Insert Table 4 about here

Hypotheses 5a, 5b and 5c propose positive moderating effects on the relationship between internationalization and firm performance by human capital, relational capital with corporate clients and relational capital with foreign government clients, respectively. The results provide support for hypothesis 5a but not for hypotheses 5b and 5c. The coefficient for the interaction of human capital and internationalization is positive and statistically significant. The coefficients for the interaction between internationalization and the two relational capital variables are not statistically significant.

To examine the moderating effect of human capital on the relationship between internationalization and performance, we graphed the relationship. As shown in Figure 3, the highest level of performance is achieved when internationalization and human capital are both high. However, the figure also shows the importance of human capital for internationalization; There is a major difference in performance when internationalization is high but human capital is low. If the firm has a low level of human capital, it will perform better if it remains in domestic markets. Thus, the human capital resource is important for successful international strategy. In turn, international expansion is important to make best use of strong human capital.

Insert Figure 3 about here

## **DISCUSSION**

International business scholars have argued for some time that entry into international markets is based on valuable firm-specific assets. Yet, few have specified the most critical

resources for successful entry into these markets. Therefore, we addressed this question in our research. The results showed that human capital and both forms of relational capital examined were important for internationalization. However, relational capital with corporate clients only had positive effects on internationalization when the firms also had strong human capital, thereby questioning arguments that firms usually follow clients into foreign markets. Prior research suggests that firms often follow important customers into foreign markets. However, our results suggest that multinational clients are interested in having law firms provide services to them in foreign markets only when they have strong human capital. The lowest level of internationalization occurred when relational capital with corporate clients was high but human capital was low. Thus, these clients likely used only the services of those firms with the strongest capabilities to help them in international markets. Alternatively, the law firms may have resisted the calls from corporate clients to service their international operations when they did not have adequate human resources to do so.

Human capital interacted positively with both types of relational capital to produce greater internationalization. Figure 2 indicates that human capital only leads to internationalization when relational capital with foreign governments is high, supporting our argument that the two variables are complementary. Alternatively, the upper graph indicates that professional service firms with low human capital were unable to realize the opportunities provided by corporate clients operating in foreign markets. The close relationship between corporate clients and the law firm (high relational capital) likely encouraged the client to advise the law firm not to enter into foreign markets if its human capital was insufficient for such an undertaking. Alternatively, if relational capital is low, information sharing is unlikely between client and the service provider.

Interestingly, the strongest predictor of internationalization was relational capital with foreign governments. We conclude that the most important resources for internationalization of the professional service firms studied are human capital and relational capital with foreign government clients. Thus, we show that the international strategy, indeed, is based on valuable resources and that human capital and relational capital are important resources for the internationalization of professional service firms.

As expected, internationalization was positively related to firm performance. Many of the law firms studied are in the intermediate phase of their internationalization where positive returns accrue. However, our results also show a curvilinear effect where internationalization beyond some point leads to decreasing marginal returns. This inverted U-shaped relationship suggests that professional service firms may eventually experience negative returns to extremely high internationalization similar to industrial firms thereby supporting the prior work of Hitt et al (1997) and Lu and Beamish (2004).

We also hypothesized positive moderating effects of human capital and relational capital. The results showed that human capital, indeed, had a positive moderating effect on the relationship between internationalization and firm performance. Law firms that increased their international scope of operations performed better when they had higher human capital. The highest performance was achieved when firms had high internationalization accompanied by high human capital. Having strong human capital helps the firms to execute their internationalization strategy. Interestingly, the lowest performance occurred when firms had high human capital but low internationalization. In these cases, the firms were not fully exploiting their human capital assets which tend to be costly. International expansion is important to make best use of strong human capital. Performance was also low when internationalization was high



and human capital was low, presumably because the firm could not effectively execute its internationalization strategy.

Interestingly neither form of relational capital had a moderating effect on the internationalization-performance relationship. In fact, examination of the main effects of relational capital provides part of the answer as to why. Relational capital with foreign government clients has a negative effect on firm performance. While it is a primary driver of internationalization, it produces negative returns. Additionally, relational capital with corporate clients produces exactly opposite effects with the two dependent variables. It is negatively related to internationalization except in the presence of strong human capital, but it has a positive main effect on performance. Yet, relational capital with corporate clients does not enhance the positive performance effects of internationalization. There is some research to suggest that corporate clients expect a “quantity discount” when providing more business to service providers. This represents a form of reciprocity, common with strong relational capital (Woolcock, 1998). And, providing services in international markets is expensive until adequate scale can be developed. However, while we find that relational capital with corporate clients enhances performance, such effects are independent from the strategy used. Alternatively, firms likely expect the relational capital to help execute the internationalization strategy (e.g., facilitate entry and operation in the foreign market) but it does not. Governments have relationships with law firms in many countries so there are competing demands for their markets. Additionally, governments want to protect their local firms from too much foreign competition. For both sets of relationships (with foreign government clients and with corporate clients), the results show the good, the bad and the ugly effects of relational capital.

This research supports the efficacy of human capital (*the good*) but also extends our knowledge of it as well. Previously, Hitt et al (2001) showed that human capital was important for domestic strategy (i.e., it was positively related to firm performance and useful in implementing domestic strategy). Our results support their conclusions but also show that human capital provides a base for internationalization. Carpenter and his colleagues found some indications of the potential value of international experience for the human capital held by a firm (e.g., Carpenter & Sanders, 2004; Carpenter & Fredrickson, 2001). While they provided an important first step, our research extends their findings to show the effect of human capital on the internationalization strategy. Additionally, our research indicates that professional service firms with stronger human capital and that internationalize enjoy higher performance. Stated differently, service firms that internationalize without strong human capital are likely to be at a competitive disadvantage. Controlling for domestic strategy, the results also suggest that firms with strong human capital can suffer lower performance when they are not internationalized because they are not effectively leveraging their human capital. Thus, there are some *ugly* aspects to human capital as well.

This research also contributes to our knowledge of relational capital. Much has been written about this construct in recent years, across several disciplines. Most of the research suggests the value of relational capital as exemplified by Dyer and Singh (1998), Nahapiet and Ghoshal (1998) and Adler and Kwon (2001). Yet, little empirical research has examined the effects of firm level relational capital on the strategy and performance of firms, in particular. We show that relational capital with clients, both corporate clients and foreign government clients, has important implications for strategy, albeit the effects are different for each. Relational capital with corporate clients only serves as a base for internationalization when the firm has strong

human capital. In fact, its main effect is marginally negative suggesting a complex relationship (*the ugly*). Thus, MNE clients are careful selecting which firms they choose to follow them into international markets and service their needs. These results suggest the limits of relational capital. They also show, however, that bundling of complementary resources is important (e.g., relational and human capital). The capability to provide good service rests on the quality of the human capital involved in satisfying service needs, the knowledge of the client and the trust between them that allows customization of the service (Sirmon et al, 2006). The importance of relational capital with corporate clients is shown by its positive main effects on performance (*the good*). Yet, this relational capital does not appear to help execute the internationalization strategy (*the ugly*).

The effects of the relational capital with foreign government clients show both *the bad* and *the ugly*. Such relational capital is a strong driver of internationalization. Yet, it does not help execute the internationalization strategy (*the ugly*). Worse, opposite of relational capital with corporate clients, relational capital with foreign governments has a negative effect on firm performance (*the bad*). In some ways, these results suggest that relational capital with foreign government clients may lead firms astray. The firms assume that it will help them enter new international markets or increase their presence in markets already served. Because of this assumed advantage (e.g., potential access to the foreign governments' home markets), the firms may provide the services for less than they would charge other clients for similar activities. Additionally, while foreign governments may desire their presence to enrich their economies, they generally do not want them to gain a competitive advantage over local firms, and indeed may help foster existing elite network advantages enjoyed by local firms (Miyazawa & Otsuka, 2005). Also, foreign governments often have law firms representing their interests in many

different foreign countries. Thus, the government does not provide asymmetric access to resources, one of the assumed benefits of relational capital. If many of these law firms establish offices in the foreign country, it increases the competition for a limited market. Therefore, we conclude that relational capital with foreign government clients encourages professional service firms to increase their internationalization but it simultaneously depresses firm profits.

Our research continues to support the efficacy of firm resources for strategy and its effect on firm performance. It also shows both the positive and ‘dark side’ of relational capital. More research should be conducted to determine the importance of human capital in other industries and the effects of relational capital as well. Additionally, this research should be replicated with firms in other industries where the critical resources are different and thereby open further the ‘black box’ regarding the value of firm resources for strategy and performance.

The research provides further knowledge regarding the internationalization of professional service firms. Clearly, resources, specifically human and relational capital, are important in their efforts to internationalize. According to recent work by Silver (2005), large U.S. law firms have continued to internationalize. And, approximately one third of the lawyers in their foreign offices were educated in the U.S. (approximately 20 percent are expatriates and 13 percent are locals with a specialized graduate degree from a major U.S. law school). Therefore, this study provides the base for future research on professional service firms. We need to understand better how they can internationalize successfully and the ways in which they can effectively implement an internationalization strategy. The poor strategic decision making and related collapse in August, 2005 by Coudrt Brothers, a leading U.S. law firm in international expansion, highlights the need for further research in this area (Glater, 2005). This event also highlights the negative curvilinear effect of internationalization on performance.

Moreover, because of the increasingly sophisticated strategies employed by the large law firms, the managing partners have begun to rely more heavily on professional managers to help operate the firms (Cooper et al, 1996). The need for effective leadership and administration has only increased with the challenges of internationalization. Spruill (2001) argued that law firms are moving toward a model where the professional managers become the COOs of the firms (with the managing partners as the CEOs). Undoubtedly, the senior partners have enhanced their knowledge of leadership and management as they gain experience with the strategies they employ such as internationalization (tacit knowledge). However, we need to learn more about how they manage their critical resources as they internationalize. Examination of how large European law firms (particularly British firms) have managed internationalization is of special interest given that they often have considerably different management styles and structures (e.g., longer-term perspectives, greater reliance on attorney seniority in firm governance) than their U.S. counterparts (Hodkinson & Novarese, 2005).

Thus, in conclusion, our research contributes valuable knowledge to both the strategic management and international management fields. Our research provides an initial step in understanding the general importance of human and relational capital to the firms' internationalization. We believe that the results of this study can be generalized to any firms where human capital and relational capital play important roles in providing their primary products or services. Yet, we recommend future research to extend this study to other industries and contexts. Also, future research might examine how human capital and relational capital co-evolve over time and how they affect the speed of internationalization.

The results provide important implications for developing and using firm resources for internationalization and its effects on performance. Internationalization strategies were never

more important than today; in fact, Thomas Friedman (2005) suggests that firms' international strategies are critical because globalization has made the world flat. Therefore, the implications of this research are important for executives and scholars alike in understanding the management of critical firm resources and the development and timing of international strategies.

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**Table 1**  
**Sample Statistics**

	Mean	Min	Max
Number of lawyers	533	227	1322
Number of foreign countries entered	3.4	0	22
Number of foreign offices	3.7	0	25
Services offered (number of different departments)	11.2	2	36
Revenue Growth (1992-1999)	91.8%	-0.4%	310.3%
Lawyers Growth (1992-1999)	39.6%	-38.7%	201.5%
Age (in years as of 1999)	96.2	25	207

Based on the 1999 data unless otherwise stated



TABLE 2

## Descriptive Statistics and Correlations

Variables	Mean	Std. Dev.	Min	Max	1	2	3	4	5	6	7	8	9	10
1. Internationalization	.23	.34	0	227										
2. Firm Performance	.36	.07	.16	.62	-.03									
3. Firm Performance (lag)	.36	.07	.16	.62	-.03	.78**								
4. Human Capital <sup>a</sup>	.00	1.00	-2.71	530	.15**	.13**	.13**							
5. Relational Capital with Corporations <sup>a</sup>	.00	1.00	-1.10	651	.11**	.21**	.21**	.05						
6. Relational Capital with Foreign Governments <sup>a</sup>	.00	1.00	-.39	7.61	.62**	-.07†	-.07†	.01	.06					
7. Firm Size	136	55.0	59	307	-.01	.35**	.38**	-.11**	.41**	.11**				
8. Leverage	2.16	.77	.78	5.44	.33**	-.34**	-.39**	.14**	.24**	.20**	-.40**			
9. Geographic Dispersion	.49	.09	.36	.64	.06	.01	-.01	.02	.08†	-.00	.06	.04		
10. Service Diversification	.75	.04	.67	.81	-.04	.04	-.08†	-.01	-.05	.00	-.07†	-.11*	.21**	
11. New York Location (dummy)	.40	.49	0	1	.47**	-.17**	-.17**	.29**	.09†	.17**	-.39**	.59**	.02	-.00

†p &lt; .10

\*p &lt; .05

\*\*p &lt; .01

<sup>a</sup> These variables were constructed based on factor score, thus mean is zero and standard deviation is one (STATA Reference, 1999).

**TABLE 3**  
**GLS Regression Analysis of Internationalization on**  
**Human Capital and Relational Capital <sup>a</sup>**

Independent Variable	Model 1	Model 2	Model 3
Intercept	-.33 (.37)	-.34 (.37)	-.34 (.36)
Firm size	.00** (.00)	.00** (.00)	.00** (.00)
Leverage	.06** (.02)	.06** (.02)	.06** (.02)
Geographic Dispersion (U.S.)	.10 (.20)	.08 (.20)	.11 (.20)
Service Diversification	.04 (.59)	.08 (.59)	.02 (.59)
Past performance	.39* (.16)	.35* (.16)	.38* (.16)
New York location	.27** (.02)	.26** (.02)	.26** (.02)
Human Capital	.02† (.01)	.03** (.01)	.02* (.01)
Relational Capital Corp.	-.02† (.01)	-.03* (.01)	-.02* (.01)
Relational Capital For. Gov	.18** (.01)	.18** (.01)	.17** (.01)
Hum. Cap. x Relational Cap. Corp.		.04* (.02)	
Hum. Cap. x Relational Cap. For. Gov.			.04** (.01)
R <sup>2</sup>	.64	.65	.66
F	83.42**	79.52**	78.17**

<sup>a</sup> Nonstandardized regression coefficients, standard errors in parentheses.

† p < .10

\* p < .05

\*\* p < .01

**TABLE 4**  
**GLS Regression Analysis of Firm Performance on**  
**Human Capital, Relational Capital and Internationalization**

Independent Variable	Model 4	Model 5	Model 6	Model 7
Intercept	.24* (.12)	.24* (.12)	.25* (.12)	.25* (.12)
Firm size	.00**(.00)	.00** (.00)	.00** (.01)	.00** (.00)
Leverage	-.03** (.01)	-.03** (.01)	-.03** (.01)	-.03** (.01)
Geographic Dispersion (U.S.)	-.08 (.07)	-.09 (.07)	-.08 (.07)	-.07 (.07)
Service Diversification	.22 (.19)	.24 (.19)	.21 (.19)	.21 (.19)
Mills Ratio	.03** (.01)	.03** (.01)	.03** (.01)	.03** (.01)
Human Capital	.01** (.00)	.00 (.00)	.01** (.00)	.01** (.00)
Relational Cap. Corporations	.02** (.00)	.02** (.00)	.02** (.01)	.02** (.00)
Relational Cap. Foreign Government	-.01* (.00)	-.01* (.00)	-.01* (.00)	-.01 (.01)
Internationalization	.05** (.01)	.03** (.01)	.05** (.02)	.06** (.02)
Hum. Cap. x Intern.		.04** (.01)		
Relational Cap. Corp. x Intern.			.00 (.02)	
Relational Cap. For. Gov. x Intern.				.01 (.00)
R <sup>2</sup>	.27	.30	.27	.27
F	16.39**	17.32 **	14.72**	14.86**

<sup>a</sup> Nonstandardized regression coefficients, standard errors in parentheses.

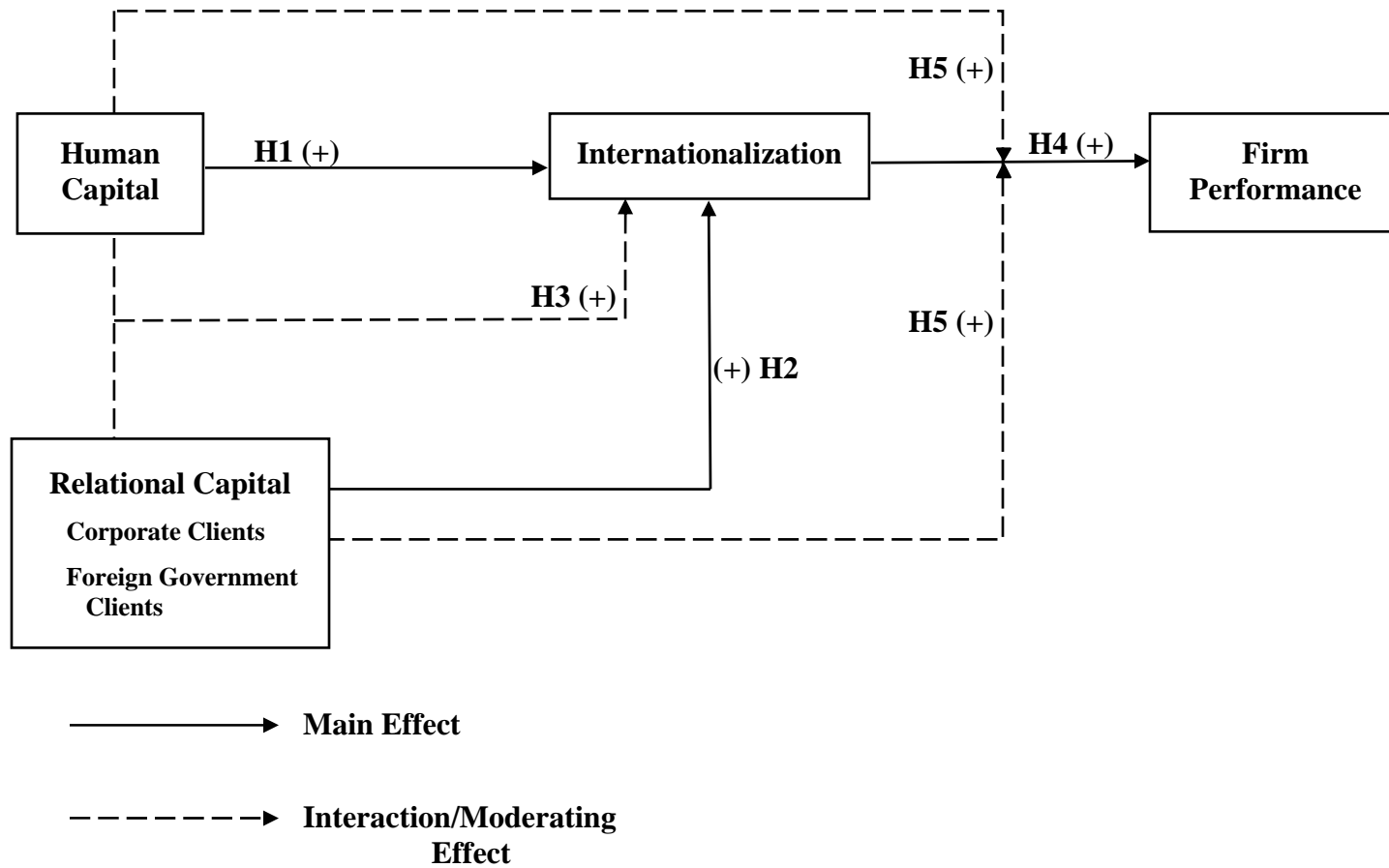
†p<.10

\*p<.05

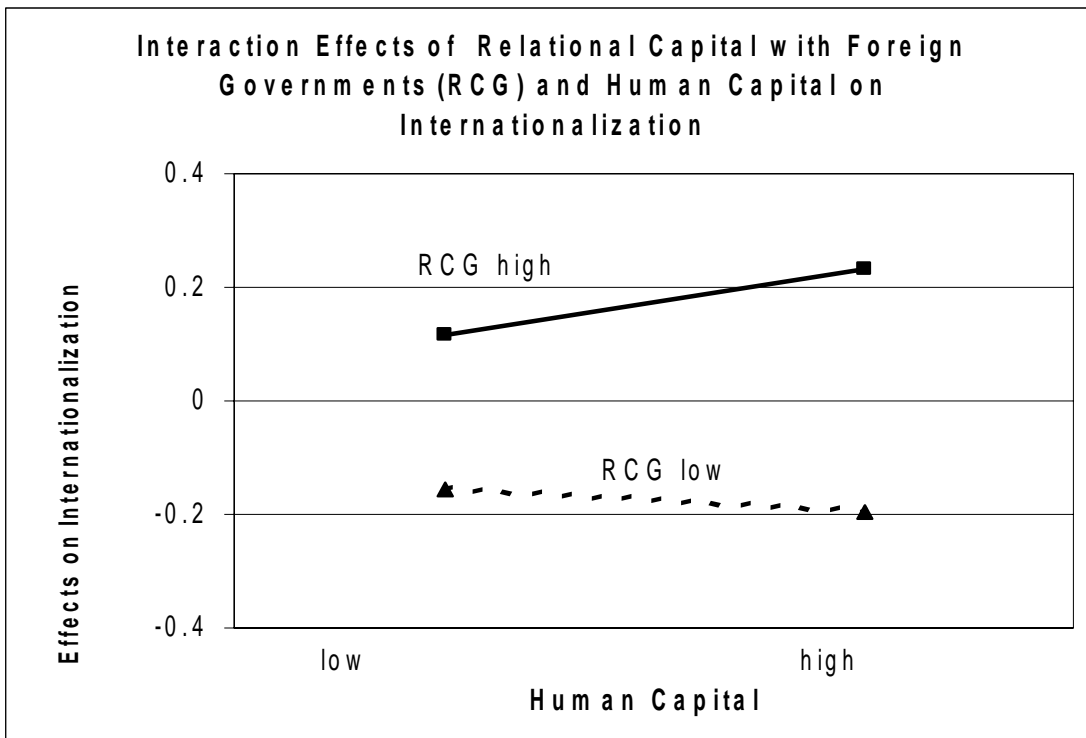
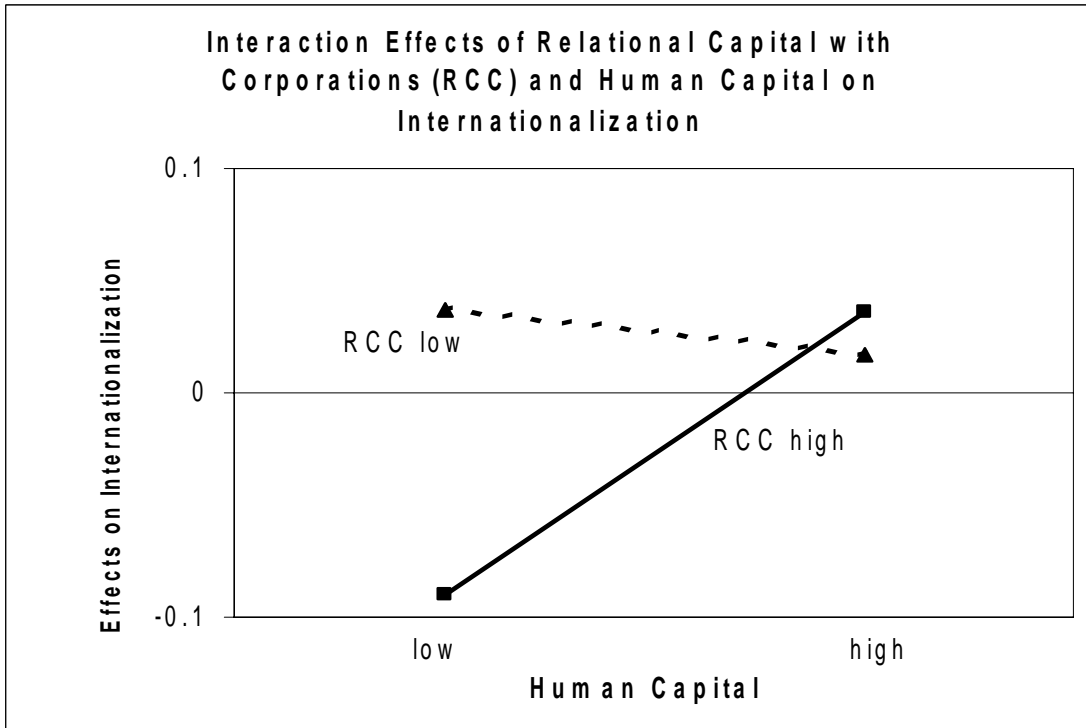
\*\*p<.01

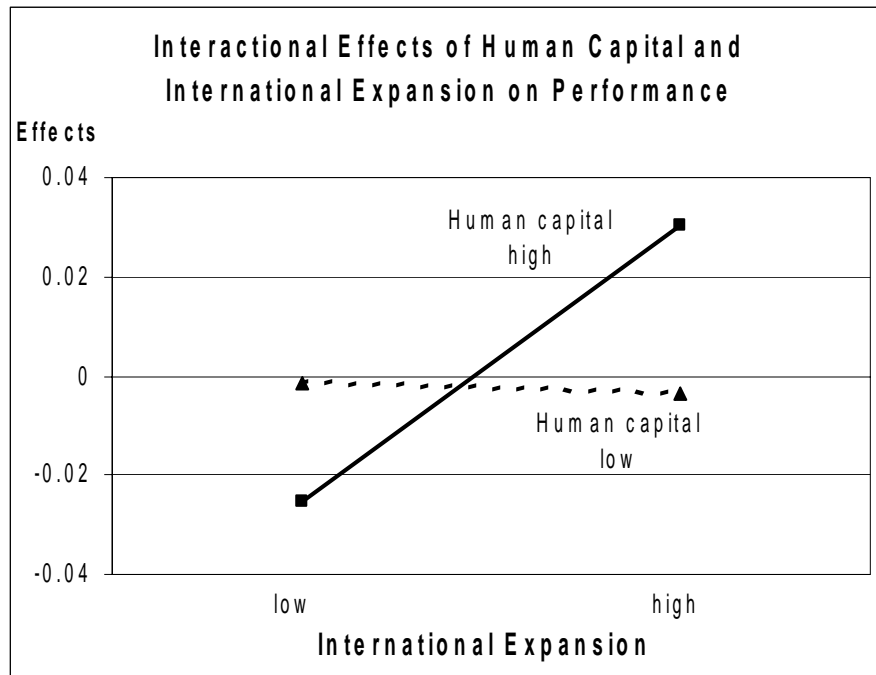
Figure 1

**Theoretical Model of the Role of Human Capital and Relational Capital in the Internationalization of Professional Service firms**



**FIGURE 2**



**FIGURE 3**

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