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THE IMPORTANCE OF RESOURCES IN THE INTERNATIONALIZATION OF PROFESSIONAL SERVICE FIRMS: THE GOOD, THE BAD, AND THE UGLY

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To further knowledge about the bases of internationalization, we examined the importance of two firm resources: human capital, and relational capital derived from relations with corporate clients and foreign governments. The results show that human and relational capital generally had a positive effect on internationalization; however, corporate client relational capital was only positive teamed with strong human capital. Additionally, human capital positively moderated the relationship between internationalization and firm performance, but neither form of relational capital moderated that relationship. Although corporate client relational capital had a strong, positive effect on firm performance, foreign government relational capital had a negative effect on performance.

Perhaps the most profound business phenomenon of the 20th century was the internationalization of large, small, established, and new venture firms (Sapienza, Autio, George, & Zahra, 2006). Accordingly, the development of multinational enterprises (MNEs) eventually led to a 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 although there is considerable research on the international strategies of large industrial firms, little research has explored the internationalization of service firms (Cooper, Greenwood, Hinings, & Brown, 1998), particularly the bases for their internationalization. One goal of the present research was 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). An assumption in most prior research is that firms go abroad to exploit strategic assets and take advantage of market imperfections, yet little is known about the specific assets firms need to successfully enter international markets. Given the extent to which many firms have internationalized and the desire of others to expand their international scope, researchers need to better understand the requirements for expanding internationally and how firms can do so successfully. Prior research suggests the motivations for internationalization include economies of scale and scope, increasing market power, gaining 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, little is known about the specific resources

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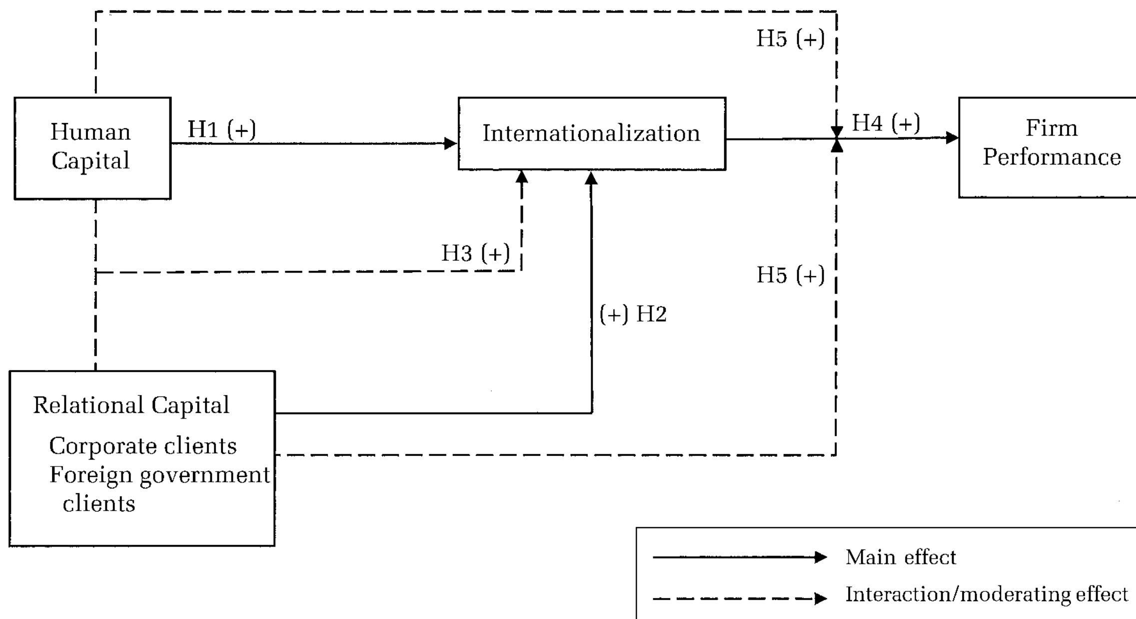
FIGURE 1
Theoretical Model of the Role of Human Capital and Relational Capital in the Internationalization of Professional Service Firms



on which international expansion is based and how they facilitate expansion to achieve the aforementioned outcomes (Tallman, 2001).

To examine the internationalization of professional service firms, we studied large law firms with home offices in the United States. These firms entered international markets slowly with the purpose of continuing to serve their United States–based multinational clients' needs (Spar, 1997). Law firms use human capital—their professional employees' accrued expertise and experience—to provide services representing intangible products such as information, knowledge, and advice related to legal questions (Hitt, Bierman, Shimizu, & Kochhar, 2001). And Spar (1997) argued that law is a business of relationships, particularly relationships with clients. The joint benefits embedded in a relationship between two or more parties has been called relational capital. 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. Figure 1 depicts our theoretical model.[1]

In this paper, we contribute to the international management literature by theoretically arguing and empirically showing a direct link between specific and important firm resources and a firm's international strategy. Moreover, we show that the holistic effects of these resources and their interaction increase internationalization. Although the literature has historically focused on resources such as technological know-how, we consider resources whose importance to firms has been recognized in recent management research (Adler & Kwon, 2002; Hitt et al., 2001) and 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 knowledge of the resource-based view of the firm. 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

[1] We expected resources to have main (direct) effects on performance, but they are not a part of our theoretical model and thus are not included in the figure. As a check, we tested for mediation by internationalization of the relationship between resources and performance. We found none to exist.

outcomes (*the ugly*). Relational capital based on relationships with corporate clients has a positive effect on internationalization only in the presence of strong human capital. Finally, the results show that relational capital based on relationships with foreign governments has a strong, positive effect on internationalization, but a negative effect on firm performance (*the bad*).

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'Connell, 1996). Particularly, the growing interrelationship of 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" (Dezaly & Garth, 2002; Slaughter, 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, by continuing to advise them on matters of U.S. law, such as how their international contracts fitted legal standards in the United States, implications of U.S. tax regulations, and so forth. They used expatriates to staff the offices, generally including an expatriate partner to oversee local foreign office operations and maintain effective relations with long-term multinational clients (Silver, 2005).

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 United Kingdom) that had entered international markets to expand their international operations (Silver, 2001). The law firms that entered 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 U.S. law schools. After they had learned the culture, general practices, and internal routines of their U.S. employers (Winter, 2005), most were transferred to the firms' local offices in their home countries.

Supported by technological advances (e.g., in information technology), 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 an "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, 2007), 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 (Hitt et al., 2001; Lepak & Snell, 1999). 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 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 providing quality legal training and education, partners' experience can be especially helpful in international markets. Silver (2000) suggested that law firms' involvement in large and complex corporate and financial transactions enables the partners with such experience to export and adapt that knowledge to local legal sys-

tems in international markets. She argued 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: 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 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 and his colleagues (2005) argued that managerial competence plays an important role in internationalization. Drawing 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, a firm's reputation and the associated trust in specific partners by clients are likely to be more important resources for professional service firms than their specialty expertise (Cooper, Rose, Greenwood, & Hinings, 2000; Grosse, 2000), especially in generating demand for the firms' services from customers in foreign countries.

The top-ranked institutions from which lawyers with the best formal educations 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 specialized graduate degrees from 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 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. A firm's human capital and its level of internationalization have a positive relationship.*

The capability of building 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 a relationship between two or more parties that is highly important to those parties (Dyer & Singh, 1998). Relational capital includes knowledge and understanding of the other party leading to shared meaning, commitment, and norms of reciprocity (Granovetter, 2005; Zucker & Darby, 2005).

Clients select from alternative service providers (Priem, 2006), choosing those who provide them the most value (Sirmon et al., 2007). Thus, 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 (Nodofor & Levitas, 2004). To protect against clients' potential opportunistic use of knowledge, service providers try to build long-term relationships. The continuity of a relationship and the amount a client is willing to pay for services reflect the quality of the relationship between 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 a 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 a 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 to a relationship interact over time, they build understanding of each other through the sharing of information, and thus shared meanings emerge in the relationship. A law firm's knowledge of a client's business, industry, and idiosyncratic policies and practices allows the law firm to customize its service for the client. The greater the knowledge of the other party, the greater the partner-specific absorptive capacity for continued learning. Absorptive capacity is the ability to acquire knowledge, assimilate it, and use it toward 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 a relationship has existed between 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 clients, 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 a firm and its client. Thus, customized, high-quality service based on idiosyncratic knowledge is valuable, rare, and difficult to imitate, and it thereby provides a 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 a service firm to extend its knowledge base, which 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, many large law firms' initial forays into international markets were for the purpose of servicing the 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. These 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 bases in those markets (Dess, Gupta, Hennert, & Hill, 1995). These relationships may also allow the service providers to form relationships with other important entities in the new markets such as government units (and officials) and suppliers. Further, a law firm can utilize capabilities that are specific to a client more effectively by expanding the services provided for this particular client, for instance by serving this client abroad.

Foreign government clients can also facilitate the international expansion of professional service firms. When a firm provides services to foreign governments in its home country, the firm learns more about the client's country, culture, and market opportunities abroad (information transfer), and the firm's reputation, especially in the home markets of the governments represented, becomes stronger (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 government regulations or lobbying legal obstacles to entering the market in that government's country (Griffith & Harvey, 2004). The relationship with a foreign government usually occurs through a contract in which the law firm represents the government in a special legal matter in the United States. 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) referred 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 (development of trust). Additionally, experience and relationships with particular foreign governments allow the law firm to develop generalizable knowledge for dealing with different regulatory and cultural environments.

Prior research has shown 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 derived from relationships with multinational clients and foreign governments to lead

to international market entry and expansion. These arguments lead to the following hypotheses:

Hypothesis 2a. A firm's relational capital in relationships with large corporate clients and its level of internationalization have a positive relationship.

Hypothesis 2b. A firm's relational capital in relationships with foreign government clients and its level of internationalization have a positive relationship.

Human capital and relational capital are independent constructs, but they also have complementary qualities. In fact, Burt (1997) suggested that relational capital is a contextual complement to human capital. Firms' relational capital enhances the value of their human capital for international expansion, and 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 people comprising the firm's human capital can learn. As human capital grows with the knowledge acquired about new international markets and about servicing clients in these international markets, the firm builds capabilities for expanding its existing international operations and entering other international markets successfully. Furthermore, relationships with large corporate clients and foreign governments often enhance 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 embodied in 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 a firm leads to better selection and more effective integration of new hires.

From a different perspective, professional service firms having strong relational capital in relationships with multinational corporate clients may desire to enter international markets, but the corporate clients are unlikely to employ them in foreign markets unless the professional service firms have strong human capital. Interpretation of U.S. law in foreign contexts is likely to be more complex and challenging than it is in the 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 clients as a primary source, even when they have strong relational capital (derived from relationships with multinational corporations or foreign governments).

Firms bundle resources to create capabilities (Sirmon et al., 2007). To enhance their capability of operating in international markets successfully, professional service firms can integrate their human capital and relational capital, given that the two are complementary (Adler & Kwon, 2002). Together, these arguments suggest an interactive (complementary) effect between human capital and relational capital on internationalization, leading to the following hypotheses:

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

Hypothesis 3b. Human capital and relational capital in relationships 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 a 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 the resource-based view suggests. 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 researchers 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 and Beamish [2003] and Tallman [2001]). In fact, later research has suggested that the relationship between international diversification and performance is curvi-

linear, taking an inverted U-shape (Hitt et al., 1997). Although 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 a firm's capabilities. Thus, further expansion produces lower firm performance. Lu and Beamish (2004), studying a large sample of Japanese industrial firms over 12 years, largely demonstrated this overall relationship. 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 a firm at an intermediate level of internationalization have had time to learn how to enter and operate effectively in international markets. They know how to overcome the costs of operating in foreign environments and achieve the benefits they afford (Goerzen & Beamish, 2003). Additionally, these managers have not exceeded the firm's capabilities to manage the international expansion.

Service firms, especially some professional service firms, differ from industrial firms in that their products (e.g., management consulting) may be universally applicable. Although legal knowledge is not necessarily applicable across boundaries, the legal services extended in the early internationalization of the U.S. law firms we 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 firms in many other industries, these law firms entered international markets slowly. Many of the firms only entered markets at the request of multinational clients and then expanded their services and client bases slowly (Spar, 1997). Although some firms entered international markets early, most started entering 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, U.S. legal firms were more successful than the typical firm in 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 cultures and markets and built local relational capital. Furthermore, most of these firms have an intermediate level of internationalization. In view of these arguments, we expect internationalization of law firms to be positively related to performance. The preceding arguments lead to the following hypothesis:

Hypothesis 4. Internationalization and firm performance have a positive relationship.

Although a positive relationship between internationalization and performance is expected, the level of resources a firm can deploy in these efforts is likely to affect the success of internationalization efforts. Firms are motivated to enter international markets 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 a firm has the appropriate resources. If it has lower 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). MNEs in international markets are less likely to use entrants with lower human capital to provide legal advice. It will also be more difficult for these entrants 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 attempts to enhance their competitiveness (Morrow, Sirmon, Hitt, & Holcomb, 2007). Yet these firms are likely to be resource-deficient or 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 international expansion and facilitate coordination between home and host country offices, thus exploiting internalization 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 expe-

rience problems in obtaining enough clientele to achieve positive returns in the foreign offices (liability of foreignness [Zaheer, 1995]). Adequate numbers of multinational corporate clients afford instant business in a new market and the legitimacy needed to obtain more business locally. However, without an adequate clientele, a firm must establish new relationships and build a new client base. Building a new client base takes time, is costly, and returns are generally low 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 firms to overcome (deal with) these institutional barriers. For example, foreign government clients can provide contacts who might help the firm to learn the nuances of regulatory policies, and they also provide their own form of legitimacy. Having little or no relational capital from relationship with the government in a foreign market, a new entrant 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 for competitors to imitate. 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 a 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 increases 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 in relationships with large corporate clients positively moderates the relationship between internationalization and firm performance.

Hypothesis 5c. Relational capital in relationships 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 in which to test the hypotheses was desirable (Dess, Ireland, & Hitt, 1990). We chose law firms because their critical resources are human capital and relational capital, as in most professional service firms (Hitt et al., 2001). Moreover, law firms were 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 U.S. law firms by total revenue published annually by the *American Lawyer*. We measured the resources, strategies, and performance of these firms for 1992–99. Because of acquisitions and consolidations as well as changes in rankings, we had data for 72 law firms over this period. Further, the lag structure used and some missing data resulted in a total of 412 firm-year observations. Table 1 shows the sample statistics.

Analytical Approach

The data were both cross-sectional (across firms) and time series (over 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 helped 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-for firm-specific heterogeneity (Goodstein & Boeker, 1991; Sayrs, 1989). Further, we incorporated a one-year lag between dependent

TABLE 1
Sample Statistics[a]

Characteristics	Mean	Minimum	Maximum
Number of lawyers	533	227	1,322
Number of foreign countries entered	3.4	0	22
Number of foreign offices	3.7	0	25
Number of departments offering different services	11.2	2	36
Revenue growth, 1992–99	91.8%	−0.4%	310.3%
Lawyer growth, 1992–99	39.6%	−38.7%	201.5%
Age in years	96.2	25	207

[a] Based on the 1999 data unless otherwise stated.

variable and independent variables because their effects will likely not be immediate (Goodstein & Boeker, 1991). Thus, values for the dependent variables covered 1993–99, and those for the independent variables, 1992–98.

Dependent and Independent Variables

Hypotheses 1–3 predict relationships with internationalization as the dependent variable, and 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 and his coauthors (2001). Firm performance was operationalized as the ratio of worldwide net income to total firm revenue. The data were derived from a profitability index reported annually by the *American Lawyer,* the API, which is the ratio of profits per partner to revenue per lawyer (Brill, 1987: 16).[2] We removed the number of partners from the numerator and the number of lawyers from the denominator; the resulting measure can be interpreted as return on sales (ROS), a preferred performance indicator in internationalization research and highly correlated with other indicators of profitability, such as return on assets (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 of internationalization (e.g., number of foreign countries) and its depth (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 has used a multidimensional approach (e.g., Lu & Beamish, 2004). In our study, the degree of internationalization of each law firm in each year was measured by an entropy measure based on the number of foreign offices and the number of lawyers in each office. The measure included both the number of foreign markets in which a firm operated and the relative importance of these markets to the firm (based on the number of lawyers) (Goerzen & Beamish, 2003; Hitt et al., 1997).[3] These data were also obtained from the *American Lawyer*.

Human capital. Our measure of human capital was similar to that used in Hitt et al. (2001) but had an additional component. This measure had three components: the quality of law school attended by

[2] These data are self-reported and unaudited. We recognize the potential for bias in any self-reported data. That said, much of the secondary data used in strategic management research is 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 information from 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. *American Lawyer* also suggested that law firms' competitors monitor these data and express concern if a firm's data appear to be odd (officials at *the American Lawyer* then ask for justification of the questioned figures).

[3] 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 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 a firm's sales revenues (Hitt, Hoskisson, Johnson, & Moesel, 1996).

partners (a proxy for articulable knowledge and prestige), the average experience of the partners in a focal firm (proxies for tacit and firm-specific knowledge, e.g., of clients), and total partner experience in the legal field averaged across the partners in 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 in a firm and the law schools from which they obtained their degrees. Quality of the law school was based on the ranking provided by the *Gourman Report* because of its comprehensiveness and high correlation with similar but more limited rankings. Checking the validity of use of the Gourman ranking to measure law school quality, Hitt et al. (2001) found a Spearman rank-order correlation between *Gourman Report* and *U.S. News and World Report* rankings 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 year immediately before the beginning year of our data) for each firm.

We used a survey to obtain data on the total firm-specific experience of partners and total partner experience for each firm, because no secondary data were 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 nonresponse 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 ($r = .08$, $p < .5$), limiting concerns about nonresponse 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, as calculated from secondary data based on the date of receipt of law degree ($r = .30$ and .26, respectively; $p < .05$); these correlations provided support for the efficacy of this measure.

Using 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, to match the time frame of the other data (1999–92). To make this adjustment, we considered the average percentage of partners leaving each firm for retirement and other reasons, using 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; $\alpha = .75$). 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 (see the 1999 *STATA Reference* for details).

Relational capital. We focus on a major source 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 reputations, 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 both major clients of law firms yet different from one another in orientation, we developed two associated measures, corporate client relational capital and foreign government client relational capital.

For the former, we identified which of the 250 largest U.S. corporations (the most important corporate clients identified from data in the *National Law Journal*) were clients of firms in our sample. For each law firm and year, we counted the number of these large corporations that were clients. The average number of major corporate 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 and thereby capture the potential international network to which law firms might have access. The data we used to calculate the ratio of international to total sales for each corporation in each relevant year were obtained from COMPUSTAT. Further, we used the length of time a law firm had 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 information sharing. Such sharing increases knowledge of the partner and allows customized service. Developing and implementing customized service requires joint problem solving between a professional service firm and its client. A corporation's retaining a law firm continuously over time is an indicator of repeated interactions. Thus, calculating a measure analogous to Gulati's (1995) measure of repeated interaction, if

law firm A served corporation X in 1992, 1993, and 1994, we coded our indicator variable 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 relationships. The internal reliability of this variable was well above recommended levels (α = .91). These three measures were factor-analyzed and loaded on one factor (eigenvalue = 2.54); standardized scores were used to construct the measure of *corporate client relational capital.*

The measure for *foreign government client relational capital* was 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 United States to the U.S. Department of Justice. These reports were available for all of the years in our study except 1992–94. For the missing years, we used averages from the previous four years. First, we created a variable that indicated the number of foreign governments that were 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 a law firm. Because the precise compensation was not listed for about 10 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 number of consecutive years that a government had been a client for a firm (repeated interactions). The internal reliability among these three indicators was well above the recommended levels (α = .89). When factor-analyzed, these three components loaded on one factor (eigenvalue = 2.46). We then used standardized factor scores to construct the variable, foreign government client relational capital. The single factors for each type of relational capital reflected 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 a firm is small, it may not be able to expand internationally even if it has high-quality human capital because the small number of partners is a constraint. More generally, the size of a firm reflects its resource portfolio or capacity for international expansion. Accordingly, we included *firm size,* measured as the number of partners in each firm, to control for 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, defined as the total number of associates in a firm divided by the total number of partners (Sherer, 1995), 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., the investment banking community, the United Nations, a concentration of global commercial banks). Additionally, most of the firms that have a specialty in international law have New York City locations. Thus, this variable controlled for the potential effects of these advantages on internationalization and its outcomes. 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 were 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 choice of strategy (Hitt, Boyd, & Li, 2004). Thus, we included firm performance $t - 1$ for time period t. We also conducted a split-sample analysis for firms with high and low performance in 1992 and pro-

jected the trend of internationalization through 1999. There appeared to be no differences in the internationalization of low- and high-performing firms (the results of the split-sample analyses are available from the authors).

RESULTS

Table 2 presents the descriptive statistics and correlation matrix. We used generalized least squares (GLS) regression analysis to test the hypotheses. The GLS approach does not allow calculations of variance inflation factors (VIFs). VIFs derived using an ordinary least squares regression (which is more conservative than the GLS for VIFs because it does not control the firm and year) and the modest correlations between the independent variables suggested that multicollinearity problems were unlikely (the highest VIF was 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).

Table 3 presents the results of testing Hypotheses 1–3. Hypothesis 1 suggests 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 states that there is a positive relationship between corporate client relational capital and internationalization. Hypothesis 2b suggests a positive relationship between foreign government client relational capital and internationalization. As Table 3 shows, the coefficient for corporate client relational capital is marginally statistically significant and negative ($p < .065$), providing no support for Hypothesis 2a. However, the coefficient for foreign government client relational capital is positive and statistically significant, thereby supporting Hypothesis 2b.

Hypothesis 3a states that corporate client relational capital and human capital interact to have a positive effect on internationalization. Likewise, Hypothesis 3b states that foreign government client relational capital 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, in Figure 2 we graphed the results using a method from Stewart and Barrick (2000). In these graphs, 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. Figure 2a shows that the highest level of internationalization is achieved

TABLE 2
Descriptive Statistics and Correlations

Variables	Mean	s.d.	Minimum	Maximum	1	2	3	4	5	6	7	8	9	10
1. Internationalization	0.23	0.34	0	2.27										
2. Firm performance	0.36	0.07	0.16	0.62	−.03									
3. Prior performance	0.36	0.07	0.16	0.62	−.03	.78**								
4. Human capital[a]	0.00	1.00	−2.71	530.0	.15**	.13**	.13**							
5. Corporate client relational capital[a]	0.00	1.00	−1.10	651.0	.11**	.21**	.21**	.05						
6. Foreign government client relational capital[a]	0.00	1.00	−0.39	7.61	.62**	−.07†	−.07†	.01	.06					
7. Firm size[b]	136.0	55.0	59.0	307.0	−.01	.35**	.38**	−.11**	.41**	.11**				
8. Leverage	2.16	0.77	0.78	5.44	.33**	−.34**	−.39**	.14**	.24**	.20**	−.40**			
9. Domestic geographic dispersion	0.49	0.09	0.36	0.64	.06	.01	−.01	.02	.08†	−.00	.06	.04		
10. Service diversification	0.75	0.04	0.67	0.81	−.04	.04	−.08†	−.01	−.05	.00	−.07†	−.11*	.21**	
11. Location in New York City[c]	0.40	0.49	0	1	.47**	−.17**	−.17**	.29**	.09†	.17**	−.39**	.59**	.02	−.00

[a] These variables were constructed on the basis of factor scores; thus the mean is 0 and the standard deviation is 1 (*STATA Reference,* 1999).

[b] Number of partners.

[c] Dummy variable.

† $p < .10$

* $p < .05$

** $p < .01$

TABLE 3
Results of GLS Regression Analysis for Internationalization[a]

Independent Variables	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)
Domestic geographic dispersion	.10 (.20)	.08 (.20)	.11 (.20)
Service diversification	.04 (.59)	.08 (.59)	.02 (.59)
Past performance	.39* (.16)	.35* (.16)	.38* (.16)
Location in New York City	.27** (.02)	.26** (.02)	.26** (.02)
Human capital	.02† (.01)	.03** (.01)	.02* (.01)
Corporate client relational capital	−.02† (.01)	−.03* (.01)	−.02* (.01)
Foreign government client relational capital	.18** (.01)	.18** (.01)	.17** (.01)
Human capital × corporate client relational capital		.04* (.02)	
Human capital × foreign government client relational capital			.04** (.01)
R^2	.64	.65	.66
F	83.42**	79.52**	78.17**

[a] Nonstandardized regression coefficients are shown, with standard errors in parentheses.
† $p < .10$
* $p < .05$
** $p < .01$

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

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. In this procedure, in stage 1 a control variable called the inverse Mills ratio is calculated (in this case, we dummy-coded internationalization and used it as the dependent variable in a probit model). Then this variable is inserted into a stage 2 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, we entered location in New York City and prior performance in the first-stage model but not in the second-stage model.

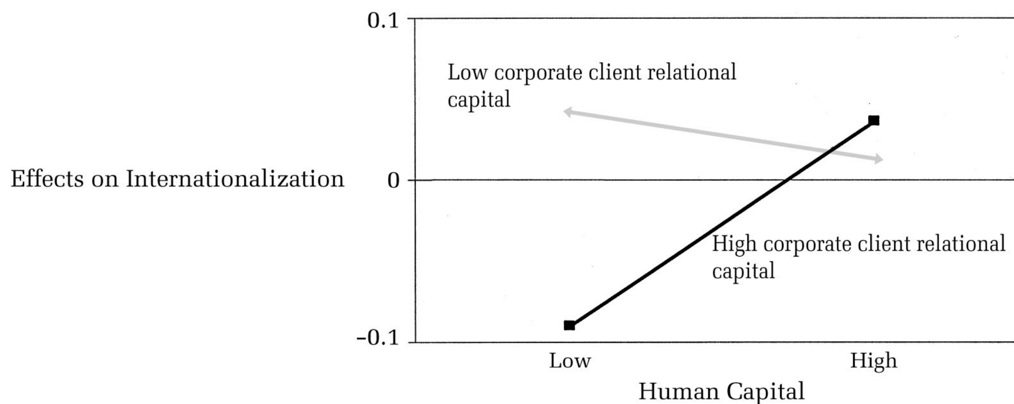
Table 4 presents the results of the stage 2 model used to test Hypotheses 4 and 5. Hypothesis 4 suggests that internationalization has a positive effect on firm performance. Table 4 shows a positive and statistically significant coefficient for internationalization, providing support for the hypothesis. In view 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, the relationship takes a form resembling the inverted U-shape found by previous researchers. Additionally, the results in Table 4 also show that human capital and corporate client relational capital have statistically significant and positive main effects on firm performance, which we did not hypothesize. However, foreign government client relational capital unexpectedly shows a statistically significant, negative effect on performance.

Hypotheses 5a, 5b, and 5c propose positive moderating effects on the relationship between internationalization and firm performance by human capital, corporate client relational capital, and foreign government relational capital, 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.

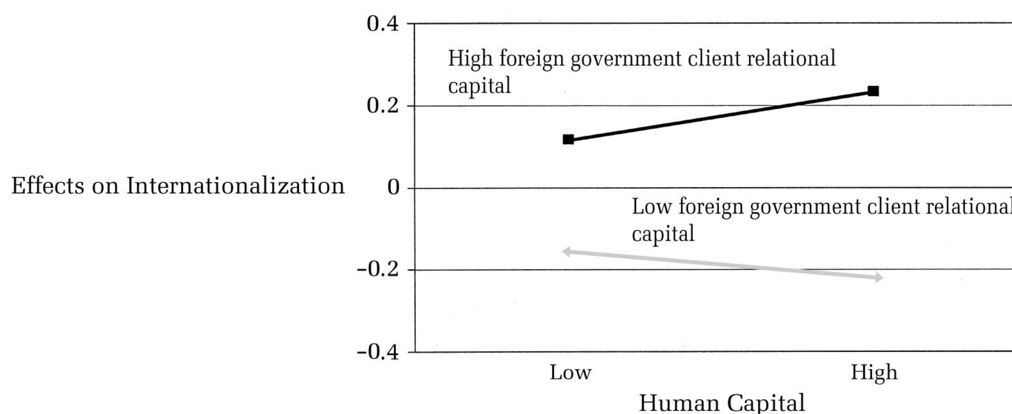
To examine the moderating effect of human capital on the relationship between internationalization and performance, we graphed the relationship. As shown in Figure 3, the highest level of performance is achieved when internationalization and

FIGURE 2

(2a) Effect on Internationalization of the Interaction of Corporate Client Relational Capital and Human Capital



(2b) Effect on Internationalization of the Interaction of Foreign Government Client Relational Capital and Human Capital



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 a 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 the best use of strong human capital.

DISCUSSION

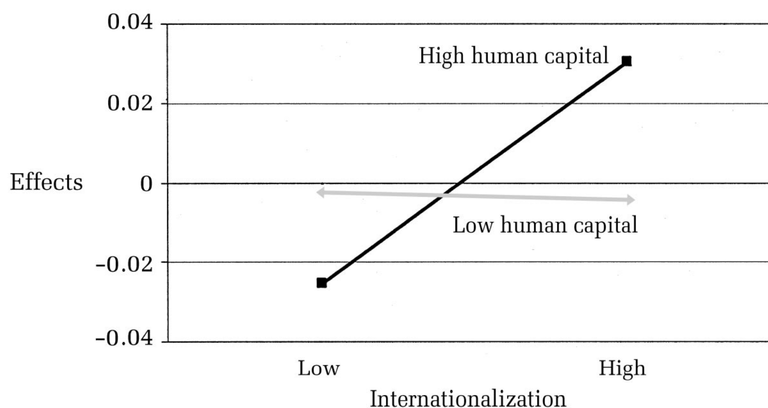
International business scholars have argued for some time that entry into international markets is based on valuable firm-specific assets. Yet few have specified the most critical resources for successful entry into these markets. Therefore, we addressed this question in our research. The results showed that human capital and both forms of relational capital examined were important for internationalization. However, corporate client relational capital only had positive effects on internationalization when the firms also had strong human capital, a finding calling into question 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 the firms 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 calls from corporate

TABLE 4
Results of GLS Regression Analysis for Firm Performance[a]

Independent Variables	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)
Domestic geographic dispersion	−.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)
Corporate client relational capital	.02** (.00)	.02** (.00)	.02** (.01)	.02** (.00)
Foreign government client relational capital	−.01* (.00)	−.01* (.00)	−.01* (.00)	−.01 (.01)
Internationalization	.05** (.01)	.03** (.01)	.05** (.02)	.06** (.02)
Human capital × internationalization		.04** (.01)		
Corporate client relational capital × internationalization			.00 (.02)	
Foreign government relational capital × internationalization				.01 (.00)
R^2	.27	.30	.27	.27
F	16.39**	17.32 **	14.72**	14.86**

[a] Nonstandardized regression coefficients are shown, with standard errors in parentheses.
* $p < .05$
** $p < .01$

FIGURE 3
Effects on Performance of the Interaction of Human Capital and International Expansion



clients to service their international operations when the firms 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 foreign government client relational capital 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 law firms (high relational capital) likely encouraged the clients to advise the law firms not to enter into foreign markets if their human capital was insufficient for such an undertaking. Alternatively, if relational capital is low, information sharing is unlikely between client and service provider.

Interestingly, the strongest predictor of internationalization was foreign government client relational capital. We conclude that the most important resources for the internationalization of the professional service firms studied are human capital and foreign government client relational capital. Thus, we show that an international strategy is indeed 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 were in an intermediate phase of their internationalization, where positive returns accrue. However, our results also show a curvilinear effect, with internationalization beyond some point leading to decreasing marginal returns. This inverted U-shaped relationship suggests that professional service firms may eventually experience negative returns to extremely high internationalization, as do industrial firms, thereby supporting the prior work of Hitt and his coauthors (1997) and of 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 firms to execute their internationalization strategies. 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 firms could not then effectively execute internationalization strategies.

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 for this absence of moderation. Foreign government client relational capital had a negative effect on firm performance. Although it is a primary driver of internationalization, this form of relational capital produces negative returns. Additionally, corporate client relational capital 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. Some research suggests that corporate clients expect a "quantity discount" when providing more business to service providers. Such discounts would represent 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, although we found that corporate client relational capital enhanced performance, such effects were independent of the strategy used. Alternatively, firms likely expected the relational capital to help them execute their internationalization strategies (e.g., facilitate foreign market entry and operation), but it did 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 academic knowledge of it as well. Previously, Hitt and his colleagues (2001) showed that human capital was important for domestic strategy, in that 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 & Fredrickson, 2001; Carpenter & Sanders, 2004). Although these researchers provided an important first step, our research extends their findings to show the effect of human capital on internationalization strategy. Additionally, our research indicates that professional service firms that have 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. With domestic strategy controlled, 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 knowledge of relational capital. Much has been written recently about this construct in 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 derived from relationships with clients, both corporations and foreign governments, has important implications for strategy, albeit the effects are different for each source of the relational capital. Corporate client relational capital only serves as a base for internationalization when a firm has strong human capital. In fact, its main effect is marginally negative, suggesting a complex relationship (*the ugly*). Thus, MNE clients are careful when 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 complementary resources is important (e.g., relational and human capital). The capability of providing good service rests on the quality of the human capital involved in satisfying service needs, the knowledge of the client, and the trust between firm and client that allow customization of service (Sirmon et al., 2007). The importance of corporate client relational capital is shown by its positive main effects on performance (*the good*). Yet this relational capital does not appear to help firms execute an internationalization strategy (*the ugly*).

The effects of foreign government client relational capital show both the "bad" and the "ugly." Such relational capital is a strong driver of internationalization. Yet it does not help execute an internationalization strategy (*the ugly*). Worse, unlike corporate client relational capital, foreign government client relational capital has a negative effect on firm performance (*the bad*). In some ways, these results suggest that foreign government client relational capital 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, although foreign governments may desire the firms' 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 governments do not provide asymmetric access to resources, one of the assumed benefits of relational capital. If many of these law firms establish offices in a foreign country, the competition for a limited market increases. Therefore, we conclude that foreign government client relational capital encourages professional service firms to increase their internationalization but 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 negative sides 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 in which the critical resources are different from those examined here for law firms; replication would further open the black box of knowledge about 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 these firms' efforts to internationalize. According to Silver (2005), large U.S. law firms have continued to internationalize, and approximately one-third of the lawyers in their foreign offices have been educated in the United States (approximately 20 percent are expatriates, and 13 percent are locals with specialized graduate degrees from major U.S. law schools). Therefore, this study provides a base for future research on professional service firms. Scholars need to understand better how these firms 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 of Coudert 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 large law firms, their 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 in which the professional managers become the chief operating officers (COOs) of the firms, and the managing partners become the CEOs. Undoubtedly, senior partners have enhanced their knowledge of leadership and management as they gain experience with strategies such as internationalization (tacit knowledge). However, researchers 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. It provides an initial step toward understanding the general importance of human and relational capital to firms' internationalization. We believe that the results of this study can be generalized to any firms in which 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 coevolve 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 have never been more important than they are today; in fact, Friedman (2005) suggested 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 seeking understanding of the management of critical firm resources and the development and timing of international strategies.

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