International diversification and performance: A study of global law firms☆

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Abstract

This paper is an exploration of the internationalization-performance relationship in the context of contemporary knowledge intensive services. After background literature, we build theory in the context of service firms to explain how performance in international diversification largely depends on building various relevant organizational competencies. We develop two hypotheses: one concerning a reverse u-shaped internationalization-performance function for these firms in general, and another differentiating between U.S. and U.K. firms. Data on 76 U.S. and 13 U.K. firms are analyzed using hierarchical regression. The findings sustain the reverse u-shaped internationalization-performance relationship for these firms in general, but also suggest that the prospects are quite different for U.S. versus U.K. firms. Our findings add to an emerging stream of research that indicates a resolution to the hitherto ambiguous internationalization-performance relationship; and we also suggest a convergence between findings in capital-intensive and knowledge-intensive industries. The paper concludes with some implications for practitioners.

Keywords: Internationalization; Diversification; Law firms

Managers wanting to expand their firms’ activities in foreign markets may well be confused—if not completely discouraged—by recent research that finds different nonlinear relationships between international diversification and various measures of profitability (e.g., Hitt et al., 2006;
Kotabe et al., 2002; Lu and Beamish, 2004; Ruigrok and Wagner, 2003). These findings are no less puzzling in the context of service industries where different zones of negative returns to international diversification have been reported (e.g., Capar and Kotabe, 2003; Contractor et al., 2003). A good example, according to Maister (2005), is that over 100 American law firms opened offices in London and almost all are unprofitable; nevertheless, he notes, most large Australian law firms are following suit—causing us to recall the words of George Bernard Shaw, “triumph of hope over experience.” Profitable international expansion can certainly not be taken for granted!

Services are increasingly important and increasingly global; and we specifically need to learn more about newly globalizing knowledge-intensive professional services (Hitt et al., 2006). This paper builds on past research on the performance implications of international diversification, specifically international diversification of service firms, and more specifically-knowledge-intensive service firms. We develop a theory of how internationalization experience trades off with varying opportunities and costs of doing business in remote markets. The industry/sector backdrop for the study is the emerging field of global law firms. We begin by reviewing relevant literature, introducing the contexts more specifically, theory building, developing hypotheses, and then discussing the method, findings, and implications of this research.

1. Literature, contexts, and theoretical bases

International diversification (ID) is a growth strategy whereby the firm seeks market opportunities offshore (Capar and Kotabe, 2003). Contractor et al. (2003) and Sarkar et al. (1999) use the term “international expansion” and Ruigrok and Wagner (2003) talk about “internationalization” to describe similar concepts, whereby strategic choices are made to commit to foreign markets. While firms generally expand internationally with an intention to improve their long-run financial performance, research on diversification in general (e.g., Graham et al., 2002; Campa and Kedia, 2002; Palich et al., 2000) and international diversification in particular (e.g., Kotabe et al., 2002; Lu and Beamish, 2004; Ruigrok and Wagner, 2003) has consistently questioned the overall efficacies of these strategies.

As yet, little research has been published on the effect of ID on performance of services in general (Capar and Kotabe, 2003) and on knowledge-intensive services in particular-notable exceptions being Contractor et al. (2003) who have a small sub-sample of knowledge-based firms; and the Hitt et al. (2006) study of the importance of human and relational capital on ID, where positive linear and negative quadratic ID-performance effects were detected among internationalizing U.S. law firms. However the findings of these studies are quite contrary, and underscore the ups-and-downs facing service firms in internationalization: Capar and Kotabe (2003) argue that initial ID necessitates investment that causes initial diseconomies of scale but economies are achievable in the longer run; and their findings support this u-shaped relationship—which suggests an initially negative effect of international expansion on performance before the positive return may be achieved. Hitt et al. (2006) rely on prior evidence to support their inverted u-shaped internationalization-performance hypothesis—which suggest initial positive returns to international expansion until some optimal level, followed by negative returns. Another recent study in the service sector (Contractor et al., 2003) builds and supports an s-shaped performance-multinationality curve, implying an initial u-shaped effect (economies then diseconomies) followed by decreasing returns. These decreasing returns are associated with highly internationalized firms expanding into peripheral markets, areas of large cultural distance, and high coordination costs in highly dispersed markets. This S-shaped curve may be one
approach to resolving the contradictory u-shaped versus n-shaped positions (and we discuss this possibility in the concluding section of this paper).

Another approach to resolving the confusion may be that the ID-performance effect is context-specific; and thus several authors have focused on certain sectors. For example, Capar and Kotabe’s (2003) sample is drawn from four German service industries; Contractor et al. (2003) distinguish between capital-intensive and knowledge intensive services; Ruigrok and Wagner (2003) compare German and U.S. firms; and Matraves and Rodriguez (2005) contrast German and U.K. firms. In this paper we build on these and other studies in an attempt better to understand the ID-performance relationship in legal services, including analysis of the country of origin effect. At the same time we build on the theoretical bases proposed by Hitt et al. (1997) to explain the ID-performance relationship namely transaction costs economics, the resource-based view of the firms, and organizational learning.

1.1. The context of service firms

Services are usually characterized as being intangible, invisible, nonfungible, ephemeral, non-storable, high fixed-to-variable cost ratio, and characterized by intense interaction between producer and user (Bowen and Ford, 2002; Hauknes, 2001). Managerial responses to characteristics like intangibility and invisibility include the emphasis on branding and reputation; while characteristics like non-storability and higher fixed-to-variable cost ratios imply relatively high pressure to sell (Porter, 1980). Consequently, services tend to be highly dynamic industries, competitive, and with intangible resources being most likely to contribute to successful competition and value creation (Hitt et al., 2006).

Our theoretical framework follows the work of Hitt et al. (1997) that shows how returns to ID are a function of the ability of the firms structure its overseas operations to reduce transaction costs and expedite information processing; and over time to learn to attract and retain the relatively rare resources (like knowledge and experience) needed for foreign competitiveness. ID can be justified if the firm can achieve some combination of revenue and transaction cost benefits relative to the investment in ID. In service firms, the revenue benefits derive from leveraging the firms brand, exclusive offerings, knowledge, experience, the ability to cross-sell, and other capabilities in a foreign market (Grönroos, 2000). Maister (2005) summarizes this set of capabilities as “a track record of being superb.” To achieve this on a global scale takes not only services with qualities that are attractive in different markets, but-on a higher level-organizational capabilities that expedite ongoing learning and other knowledge transfer among the scattered parts of the organization. Barney (1991) describes these complex social relations between the firm and its customers as “positive firm reputations” (115); and the complex, deeply embedded “information processing systems” (114) that expedite the quick flow of large amounts of information; both of which may be sources of sustained competitive advantage.

Based on transaction cost theory, Roberts and Greenwood (1997) argue that because organizations exist to provide a more efficient way (than markets) to do business, firms continuously need to strive for efficiencies in order to survive. Efficiencies for internationally expanding firms may come from economies of scale (spreading fixed costs over larger output), economies of scope (benefits from sharing resources), and experiential knowledge (defined by Blomstermo et al., 2004, as “knowledge about how to internationalize”). Operational efficiencies are generally more likely to be present in manufacturing and other capital-intensive industries.

1 Retail/wholesale, utility, IT, and tourism.
than in services where generally the entire value chain needs to be replicated\(^2\) in each location (Contractor et al., 2003). Katrishen and Scordis (1998) found that economies of scale are available to multinational insurers—at least up to a point before diseconomies become a problem for very large organizations—largely by successful integrative and centralizing activities. They recommend that globalizing firms “develop new organizational systems to manage the factors that affect economies of scale” (320).

However, the firm’s ability to succeed in ID requires the overall capability to achieve both the revenue and cost benefits outlined above. We suggest that this is a set of dynamic capabilities (Eisenhardt and Martin, 2000) that includes ongoing filtering and learning from new sources of information about clients, competition, costs, and technologies. Blomstermo et al. (2004) use the term “experiential knowledge” to include a wide range or accumulated knowledge concerning the firm’s international operations in various markets, and the capability to exploit this knowledge in an ongoing and effective way. Hadley and Wilson (2003) similarly discuss “experiential knowledge” as a key capability for the internationalizing firm. We will show below how the firm’s ability to accumulate and exploit these capabilities necessarily varies over the ID spectrum. The following section adds details of the specific sector in which this research is situated.

1.2. The context of global law firms

We use the global moniker referring to the very largest (e.g., top 100) law firms in the world (see Fig. 1), all of whom are internationalized to some extent: although a few of them have offices in only one country, even these have significant overseas clients. The vast majority of law firms are tiny, comprising perhaps a single professional or a small partnership; and their work is also mainly local, be it transferring a home from one family to another or representing a client in a local court. Global law firms, on the other hand, tend to focus more on investment banking, major litigation usually involving a multinational and/or governmental organization, and transactional law (e.g., contracts, patents) for similar large organizations (Pinnington and Morris, 2003). These firms are highly competitive, profit oriented, and place substantial emphasis on the annual ratings of firms based on various profitability and growth measures\(^3\) (Cannon, 1997; Carlson, 2004; Denny, 2003; 2004; Flood, 1999).

Why do law firms become global? One powerful pull to globalize is from client demand for the service provider to follow them in overseas expansion activities (Contractor et al., 2003; Rose, 1998). Löwendahl (1997) presents three categories of clients that may benefit from an internationalized professional service firm, namely (1) global clients that prefer the same service provider in the various country markets in which they do business, (2) local clients that require some globally standardized services\(^4\), and (3) local clients who simply prefer a global professional service provider for a variety of reasons like perceived quality, global knowledge sharing opportunities, or personal preferences. Further, a firm’s proven ability to shift product–market focus (i.e., diversify) is also a defensive foil against possible invasion of their turf by competitors—a proven capability for retaliation against a competitor entering a firm’s home turf; or at least credible threat of a counterattack, is a signal that warns off the threat of new entrants (Porter, 1980). So there seems to be some combination of contingent financial reward, pulls from

\(^2\) We are grateful to a JIM reviewer for this point.

\(^3\) We expand on this point some more in the Methods section where the measurements of performance are justified and explained.

\(^4\) Löwendahl calls this category Local clients with global “problems” (1997: 152).
existing clients, and deterrence that induce professional service firms to cross national borders. In the following section we extend the above theoretical bases and develop some testable hypotheses concerning ID and performance in the global law firm context.

2. Hypothesis development

In investigating how law firm ID might relate to performance, a key is to recollect the capabilities mentioned above: the organization, reputation, and information systems that enable exploitation of revenue benefits; combined with the organizational ability to exploit scale and scope efficiencies; and the general experiential knowledge. These capabilities are far from germane to law firms in general, who have historically developed a local (not a global) focus on nearby clients and legal systems. Firms with well developed capabilities—such as reputation or client relationships—may well grow by attracting new clients to their established services, cross-selling new services to existing clients, or developing new services close to their range of expertise (Maister, 1993). However, there are likely to be limits to these diversification capabilities. The internationalizing firm must constantly cope with the inefficiencies involved with entering remote markets, unfamiliar legal systems, and foreign cultures (Hitt et al., 1997). The above survey of relevant literature indicates mixed aggregate relationships (u-, n- and s-shaped) between ID and performance. As such we do not propose to reduce these complex relationships to a simple, linear model linking international diversification and performance. Instead, building on theory and the limited findings for internationalizing services, and applying them to the law context leads us to predict quadratic ID-performance relationships as outlined in the paragraphs that follow.

First we consider the firm at the early phase of internationalization—e.g., a firm with less than 10% of their lawyers abroad. It seems that the general expansion model followed by successful law firms is initially to build a network of domestic offices from which to launch international expansion. In this way they begin to achieve what Hitt et al. (1997:789) refer to as “the learning needed to prepare for managing international diversification.” For example when San Francisco-based Pillsbury Madison and Sutro wanted to go global they first merged with New York-based Winthrop (in 2001) 5 to form a more solid domestic base from which to launch international operations (Cranston, 2003; http://www.pillsburylaw.com). Most of the capabilities discussed above—namely, organization, reputation, information systems, efficiencies, and general

5 They later also merged with Washington, DC-based Shaw Pittman in 2005 (Jones, 2006).
experiential knowledge—are also needed to build a successful domestic network. Thus we can expect that when we look at the population of early ID firms we are looking at firms who likely have these key capabilities.

Further, when knowledge intensive service firms initially move abroad (i.e. at low levels of ID) they generally are able to take advantage of new business opportunities with very little added investment in infrastructure. For example, as Spar (1997) describes, they may follow existing clients abroad, they may establish one or two offices in foreign locations where there is growing demand for their services, and/or acquire a local firm that suits their needs. Organizational changes are slight, retaining what Perlmutter (1969) would call an “ethnocentric” mentality whereby management control, leadership, and systems come from the home country. This initial phase, then, is likely to be profitable due to the fact that the law firm can take advantage of extant business opportunities with minimal risk, need for structural reorganization, and major expenditure.

We can then identify an intermediate stage of ID where the firm has committed substantially to its overseas offices, approaching about a third of all professionals being based abroad. For those firms that continue to internationalize we can assume that the initial experience of ID was positive, and the firm can now use this experience to continue to expand into attractive markets. Perlmutter (1969) calls this the “polycentric” phase, wherein the firm begins to identify with the foreign markets in which it now operates. Advantages of scale and scope—like reputation, host country support, extension of product life cycles, and overseas know-how—become available, and contribute to continued profitability at this phase (Contractor et al., 2003). On the other hand, the polycentric firm obviously cannot only rely on following a constant flow of home country clients, and thus needs to compete for overseas clients in foreign clients—and this competition generally drives down margins. Some of the capabilities that initially served the firm well in its growth phase may no longer fit. For example, the information systems may no longer be adequate and the organizational capabilities may be strained by greater distances. Additional investment is also likely to be required in offices and other infrastructure.

The final phase would be when the firm reaches high levels of ID, whereby more than half their professionals are outside the home country. The firm has evolved away from its home country orientation to be truly multinational or “geocentric” (Perlmutter, 1969). However, the relatively simple organization structure and infrastructures that served the firm when it was primarily located in its home base need to be replaced by necessarily more complex systems to cope with the myriad legal, cultural, tax, and geographic context with which it needs to deal. At this stage the firm would have to invest in separate international management, IT and control infrastructures; often with regional administrative offices overseas as well. Katrishen and Scordis (1998) suggest that diseconomies of scale may plague large service firms. Perlmutter (1969) identifies further costs associated with communication, travel, education, and decision-making time. Contractor et al. (2003:16) suggest that “knowledge-intensive firms can easily ‘over-expand’ into suboptimal” peripheral markets characterized by cultural distance and increasing coordination costs.

Together, these three phases of internationalization-performance describe an \( \cap \)-shaped (or inverted u-shaped) relationship. Support for this inverted u-shaped relationship is provided by Hitt et al. (2006) in their study of 72 U.S. law firms between 1992 and 1999. Therefore:

**H1.** The aggregate relationship between international diversification and performance of global law firms will resemble an inverted u-shaped curve.
2.1. Country of origin

There have historically been two dominant domains for global law firms, namely London and New York. Listings of the largest global law firms feature a majority of American firms, but a significant minority of strong, highly global U.K. firms. Although Nachum (2003) concludes that firm-specific attributes have a stronger effect on performance of professional service firms than home-country factors, country of origin effects still moderate the behavior of these firms (Flood, 1999). Ruigrok and Wagner (2003) surmise that the diversification-performance relationship would be very different for U.S. versus European firms—and although their study is based on manufacturing firms, we build on some of their logic below. We thus present the following arguments why the shape of the relationship between ID and performance will be influenced (or moderated) by the firm’s country of origin.

Because the majority of global law firms are of U.S.-origin the above \( \cap \)-shaped theory was developed from an American perspective: Before these firms internationalize they first develop an extensive interstate network of offices in North America; then they follow established existing clients overseas and/or cherry-pick lucrative foreign centers of commerce, trade and governance (Rose, 1998). They thus are able to commence work immediately for familiar clients and in familiar areas (such as contracts and trade) which allow them to operate profitability from the start. However, the U.K. and most other European countries do not have several separate centers of government and commerce which offer the opportunity (and experience) of building a domestic network of offices. As a result the European firm is more likely to take its first steps abroad with less experience of geographic (or spatial) diversification in general, with less critical mass, and thus off a less solid base than their American counterparts (Capar and Kotabe, 2003). European firms are thus more likely to find that their initial steps into foreign markets require learning new languages, adapting to foreign law court systems, and managing their offices under localized employment arrangements (Flood, 1999). As Ruigrok and Wagner (2003:78) say, “unlike U.S. firms, German companies have been obligated to pursue culturally unrelated expansion strategies at the outset of foreign expansion.” It is thus likely that the initial ID steps of European firms would detract from overall firm profitability as they cope with the costly investments in what they hope will become a global law firm.

However, for those (relatively few) European law firms that survive the initial steps of entering foreign markets, the benefits of ID are likely to accrue once they become more polycentric and can capitalize on their hard-earned experience, reputation, organization, information systems, and other capabilities as regional or global law firms. These advantages are more likely to continue in their geocentric phase, as they find that European unity presents opportunities to enter several additional “foreign” markets with minimal additional investment and building off existing managerial capabilities. This is very much the story behind four of the ten biggest law firms in the world: Clifford Chance, Freshfields, Linklaters, and Allen and Overy. All four originate in London, but now are in about 20 countries, and have about 50% of their lawyers outside the U.K. (www.legalbusiness.co.uk). In fact, on average, the U.K. law firms are more international than the American firms—an issue to be discussed later. Support for these ideas come from Capar and Kotabe (2003) who found a u-shaped ID-performance relationship from their German service firms; and from Ruigrok and Wagner (2003) who conclude that the internationalization-performance relationship may be u-shaped for German firms and \( \cap \)-shaped for U.S. firms, as the

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6 See www.law.com for example.

7 More details on the sample and country of origin will be provided in the Methods section.
former tend to diversify early into unrelated markets (which hurt returns) while Americans opt for related markets early-on (which helps returns) and later move further away from home. Therefore:

**H2.** Country of origin will moderate the relationship between internalization and performance of global law firms in such a way that this relationship will resemble an inverted u-shaped curve for firms of U.S. origin, but a u-shaped curve for those of U.K. origin.

In the following section we describe our data sources, analyses, and results.

3. Method

3.1. The data

We collected data on the world’s largest law firms from *The American Lawyer* ([www.law.com](http://www.law.com)) and *Legal Business 100* tables ([www.legalbusiness.co.uk](http://www.legalbusiness.co.uk)). These tables list the top 100 law firms by revenue, profits per partner, and several other measures. We collected data for the year 2003; however, due to some missing data and an outlier, we were able to work with data from only 89 firms. Of these, 76 are U.S. firms (or global firms originating from the U.S.) and 13 British. A small number of Australian, Canadian, and Continental European firms that have appeared in the second half of these top-100 rankings were among those eliminated for missing data. A correlation matrix and other descriptive statistics appear in Table 1.

3.2. Independent variables

3.2.1. International diversification

We used two measures of the extent of ID of these firms: percentage lawyers abroad and number of countries in which the firm has offices. Due to the very high correlation between the two measures (0.92; see Table 1) we used them separately and (predictably) got almost identical results (more details will be provided later). Percentage lawyers abroad is a similar measure to the FSTS (foreign sales to total sales) measure used as a sole indicator of ID by some authors (e.g., Capar and Kotabe, 2003; Ruigrok and Wagner, 2003) and as part of a composite ID measure (e.g., Contractor et al., 2003).

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8 Our statistical software constantly indicated that the firm Wachtell, Lipton, Rosen & Katz is an outlier, and we subsequently eliminated their data from our analyses. This firm has been the topic of several case studies and also scholarly analysis (e.g., Starbuck, 1993) confirming their status as a truly exceptional organization. For example, their profitability has averaged around $3 million per partner, 5.5 standard deviations above the mean for these top-100 firms.
3.2.2. Country of origin
A dummy variable was used, U.S. = 0, U.K. = 1.

3.2.3. Size
Firm size, via its association with market power, is generally considered to be related to profitability (Buzzell and Gale, 1987). Larger firms may also have more difficulty sustaining growth rates. Firm size was measured by the natural logarithm of the total number of lawyers in the firm. Log transformation makes the results easier to interpret, and also makes the distribution of data closer to normality (Contractor et al., 2003).

3.3. Dependent variable
We used two measures of firm performance. First, because the prime objective of these large law firms is the maximization of partner profits (Carlson, 2004; Denny, 2003; 2004; Flood, 1999; Lowendahl, 1997; Sherer and Lee, 2002), we used profits per equity partner (PEP) as an indicator of returns to shareholders (equity partners). The second performance measure is an approximation of return on sales (ROS) suggested by Hitt et al. (2006), which is computed by dividing total firm profits by total firm revenues.

3.4. Analyses and findings
The 89 mega-law firms present some interesting descriptive statistics. For example, mean profits per partner were $877,550 and mean return on sales 36% (see Table 1). Average firm size was 750 lawyers. The U.K. firms are bigger and more international (remembering that the coding was U.S. = 0, U.K. = 1). More specifically, U.K. firms are significantly higher than the Americans on both ID measures: the percentage of lawyers abroad (36.71% versus 10.17%, t = 5.9, p < .0001) and the number of offices abroad (12.46 versus 4.22, t = 5.1, p < .0001). There are also strong positive correlations between the size variable and both ID measures, showing that the bigger the firm the more likely it is to have a large international network of offices and lawyers. None of the correlations between the indicators of internationalization and the performance are significant—findings reminiscent of much of the research surveyed earlier.

We applied hierarchical regression analysis using SPSS to explore the effect of ID on firm performance. Following Capar and Kotabe (2003) and Contractor et al. (2003), we began by comparing the fit of different models (steps described below) using our first performance measure, PEP, as the dependent variable. The results of these analyses are shown in Table 2. In complex models (such as cubic and other complex interaction models) the independent variables (linear, quadratic, and cubic) tend to exhibit extremely high multicollinearity because of the way they are computed. (For example, we expect multicollinearity between ID and ID$^2$.) This phenomenon is often called spurious multicollinearity (because it is mathematical in nature). Where high intercorrelations are presented the regression solution tends to be unstable, due to extremely low tolerance (or extremely high variance inflation factor, or VIF) for some or all of the predictors (Fox, 1991). We introduced the quadratic term to the regression equation, the tolerance for the linear term (ID) was 0.093 and the VIF value was 10.76; while the tolerance for the quadratic term (ID$^2$) was 0.10 and the VIF was 9.74. When we introduced the cubic term to the regression equation, the tolerance for linear, quadratic, and cubic terms were 0.037, 0.007, and 0.015 respectively, and the VIF values for these terms were 27.4, 150.5, and 66.5 respectively. Obviously, both indexes suggested a serious problem of multicollinearity. Standard error is
doubled when VIF is 4.0 and tolerance is 0.25, corresponding to $R_j^2 = 0.87$. Therefore $VIF \geq 4$ is an arbitrary but common cut-off criterion for deciding when “too much” multicollinearity (Fox, 1991). To overcome this problem we applied an orthogonalizing procedure, which uses regression residuals to represent quadratic, cubic and other complex interaction terms, thus avoiding any spurious multicollinearity (Saville and Wood, 1991). This is the reason that some of the $\beta$ coefficients (ID$^2$ for example) are stable from model to model.

In the first step, origin, size, and the linear effect of international diversification$^9$ were entered into the regression equation. As can be seen in Table 2, the linear effect of ID in this model ($\beta = 0.20$) is not significant, and in general the model demonstrates poor fit to data (adjusted $R^2$ is essentially zero). However the explanatory power of the model is improved when the squared term of international diversification (ID$^2$) is entered into the model in the second step, resulting in significant increase of 11 percent in the model adjusted $R^2$ ($\Delta R^2 = 11.62, p < .001$). The quadratic effect is negative and significant ($\beta = -0.37, p < .001$), thus indicating an inverted u-shape as described in Hypothesis 1. The direct effect is positive, but of minor significance ($\beta = 0.23, p < .10$).

Fig. 2 shows the fitted regression curves (linear and quadratic) generated by SPSS. The highly significant $R^2$ statistic serves as a goodness of fit indicator for the quadratic model. It is also interesting that the ID term is positive and marginally significant at the 0.1 level in most of the models, agreeing with the Hitt et al. (2006) hypothesis that most of these firms are in the early stage of internationalization and thus on the upward part of the inverted u-shaped curve.

### 3.5. Country of origin

We used hierarchical moderated regression to explore whether the country of origin qualifies the pattern of the effect of international diversification. The results of this analysis are shown in step 3 of Table 2. The base-line model is the significant quadratic effect model that was introduced earlier. To test our hypothesis regarding the moderating role of the country of origin, we add to the quadratic effect model (introduced earlier), the interaction term (i.e., multiplication) of the

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$^9$ At this stage we used percentage of lawyers abroad as the ID measure. The two ID measures are so highly correlated that using either measure gives almost identical results.

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Table 2
Hierarchical regression assessing the pattern of the effect of international diversification on PEP ($n=89$)

<table>
<thead>
<tr>
<th></th>
<th>Linear model (step 1)</th>
<th>Curvilinear model (step 2)</th>
<th>Interaction model (step 3)</th>
<th>Cubic model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origin country$^a$</td>
<td>-.08</td>
<td>-.24$^*$</td>
<td>-.23$^*$</td>
<td>-.24$^*$</td>
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<tr>
<td>Firm’s size</td>
<td>-.13</td>
<td>-.03</td>
<td>-.08</td>
<td>-.03</td>
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<tr>
<td>ID$^b$</td>
<td>.20</td>
<td>.23$^*$</td>
<td>.25$^*$</td>
<td>.23$^*$</td>
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<tr>
<td>ID$^2$</td>
<td>-.37$^{****}$</td>
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<td>I</td>
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<td>ID$^3$</td>
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<td>$R^2$</td>
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<td>.14</td>
<td>.20</td>
<td>.16</td>
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<td>Adjusted $R^2$</td>
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<td>.10</td>
<td>.16</td>
<td>.11</td>
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<tr>
<td>$\Delta R^2$</td>
<td>.11</td>
<td>.06</td>
<td>.01</td>
<td></td>
</tr>
<tr>
<td>$\Delta F (df)$</td>
<td>.72$^{(3, 85)}$</td>
<td>11.62$^{****}$ (1, 84)</td>
<td>6.38$^{****}$ (1, 83)</td>
<td>1.36(1, 83)</td>
</tr>
</tbody>
</table>

$^a$ U.K. = 1; U.S. = 0.

$^b$ ID = international diversification (% lawyers abroad).

* $p < .10$, ** $p < .05$, *** $p < .01$, **** $p < .001$. 
$I$: interaction effect (Origin country $^*$ ID$^2$).
country of origin and the quadratic effect (ID$^2$). The results indicate that the interaction term (I) is significant ($\beta=.25, p<.01$) and contributes an additional 6% to the explained variance in performance above the variance explained by the quadratic effect—i.e., the adjusted $R^2$ increased from .10 to .16 ($F=6.38, p<.01$). While, on the one hand we note the statistical significance of the result, on the other hand we should recall that the U.K. sample size is small ($n=13$).

Further, the regression curves generated by the SPSS statistical program (Figs. 3 and 4) clearly show that the pattern of effects in U.K. and U.S. firms are opposite. That is, as mentioned in Hypothesis 2, the inverse u-shaped curve characterizes the effect of ID on U.S. firm performance, while a u-shaped curve characterizes the U.K. firms. Separate regression analyses for each of these countries suggest that the quadratic effect for the U.S. firms is negative and significant ($\beta=-.40$, $p<.01$).
while the quadratic effect for the U.K. firms was highly positive but failed to reach the conventional level of significance ($\beta=.78, p<.12$). This non-significant finding might result from the small ratio of sample size to variables, or from high correlation between size and internationalization of the U.K. firms ($r=.71$), which introduces some degree of multicolinearity. (The correlation between these two variables for the U.S. sample is only .44). When firm size is not controlled the quadratic effect for U.K. firms is significant ($\beta=.92, p<.05$). For the U.S. firms, results are virtually identical if the firm size is not controlled (the standardized regression effect for the quadratic effect is $\beta=-.41, p<.001$). Parallel procedures using the number of offices abroad as a proxy for ID yielded similar results, although the size of the effects was smaller.

Following Contractor et al. (2003) who find an S-shaped, cubic ID-performance relationship, we tested the cubic effect ($ID^3$) in an additional model. As can be seen in the final column in Table 2, this variable did not contribute to the model fit and did not change the signs or the size of the quadratic and the linear effect. Thus we accepted the more parsimonious quadratic model, and the cubic effect was omitted from further analyses.

We then repeated the initial three steps using the second measure of performance, return on sales (results shown in Table 3). For this dependent variable the quadratic effect for the whole sample is not significant ($\beta=-.18$, n.s.), but the $ID^3 \times$ country interaction is significant ($\beta=.21, p<.05$) and significantly contributes (4.3%) to the explained variance in firm’s returns above the variance explained by the firm’s size, ID and $ID^2$ ($\Delta F=3.9, p<.05$). Again, the regression curves generated by the SPSS statistical program clearly show that the pattern of effects in U.K. and U.S. firms are opposite. Further, separate regression analyses for each country, controlling for the firm’s size, suggest that the quadratic effect is negative and significant for U.S. firms ($\beta=-.24, p<.05$), but positive and minor significant for U.K. firms ($\beta=.93, p<.09$).

In sum, we find no overall linear ID-performance effect for global law firms. However, as hypothesized, we find an inverse u-shaped curve for the entire sample, a similar inverse u-shaped
curve for the American firms, and a u-shaped curve for the small sub-sample of U.K. firms. In the following section we discuss these findings and their implications.

4. Discussion and implications

This paper generally took up the calls of Capar and Kotabe (2003) and Contractor et al. (2003) to dig deeper into the international diversification-performance relationship in the context of service firms. Our findings add to an emerging stream of research that suggests a resolution to the hitherto ambiguous research results on international diversification in general and for service firms in specific. As suggested by Ruigrok and Wagner (2003), and derived further ahead of Hypothesis 2 above, the business realities of the internationalizing American firm are different from those in Europe; and these differences suggest the contrasting u-shaped and reverse u-shaped ID-performance relationships. Our findings add to the growing evidence that the prospects are quite different for American versus U.K. firms. While findings by Capar and Kotabe (2003) support the European side of the thesis in the service sector and those in the Hitt et al. (2006) law firm study support the U.S. side, this is the first study that has examined the moderating effect of the country of origin on the relationship between internationalizing and performance of service firms.

Further, the opposite patterns in the two countries may contribute to the understanding of the mixed results in previous studies. A generation of prior research in the internationalization-performance relationship (e.g., Kotabe et al., 2002; Lu and Beamish, 2004; Palich et al., 2000) has struggled with ambiguous results, and perhaps the fact that many samples contain both American and European firms has been a cause for the blurred overall effects. Future studies that make explicit the country of origin effect are clearly indicated.

It is interesting that our findings support a theory developed by Ruigrok and Wagner (2003) from their study of manufacturing firms, and thus call into question the bifurcation between capital-intensive and knowledge-based sectors with regards to internationalization-performance issues. On the one hand there are clearly different drivers of profitability from industry to industry—or, different kinds of resources (Hitt et al., 2006). Considering the investment needed in plant and equipment, Contractor et al. (2003:11) claim that “barriers to entry will be less onerous for knowledge-based... than capital-intensive sectors.” However perhaps the evolving trend towards more effective

| Table 3 |
| Hierarchical regression assessing the pattern of the effect of international diversification on ROS (n = 89) |

<table>
<thead>
<tr>
<th></th>
<th>Linear model (step 1)</th>
<th>Curvilinear model (step 2)</th>
<th>Interaction model (step 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origin country</td>
<td>−.09</td>
<td>−.16*</td>
<td>−.15*</td>
</tr>
<tr>
<td>Firm’s size</td>
<td>−.10</td>
<td>−.06</td>
<td>−.11</td>
</tr>
<tr>
<td>ID</td>
<td>.17</td>
<td>.19</td>
<td>.21*</td>
</tr>
<tr>
<td>ID²</td>
<td></td>
<td>−.18</td>
<td>−.18</td>
</tr>
<tr>
<td>I</td>
<td></td>
<td></td>
<td>.21**</td>
</tr>
<tr>
<td>( R^2 )</td>
<td>.02</td>
<td>.05</td>
<td>.09</td>
</tr>
<tr>
<td>Adjusted ( R^2 )</td>
<td>−.02</td>
<td>.03</td>
<td>.03</td>
</tr>
<tr>
<td>( \Delta R^2 )</td>
<td></td>
<td>.03</td>
<td>.04</td>
</tr>
<tr>
<td>( \Delta F (df) )</td>
<td>.52(3, 85)</td>
<td>2.53(1, 84)</td>
<td>3.89**(1, 83)</td>
</tr>
</tbody>
</table>

* \( p < .10 \), ** \( p < .05 \).
I: interaction effect (origin country * ID²).

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a U.K. = 1; U.S. = 0.
b ID = international diversification (% lawyers abroad).
management of global value chains (Luo, 2002) has ameliorated the overall costs of capital-intensive manufacturing and distribution for global players, and thus partially erased the differences between capital and knowledge sectors. Furthermore, contemporary knowledge-intensive work also requires significant investment in infrastructure (like information systems) as well meeting the high costs of compensation for global knowledge workers. The mean profits per partner figure in our sample of close to $900,000 per year hints at the high costs of the human capital applicable in these contexts. Further research is clearly indicated to test this “convergence” hypothesis on the one hand, and to investigate the finer, industry-specific indicators of performance for internationalizing firms in a variety of industry contexts.

Returning simultaneously to the idea of industry-specific drivers of performance and law firm context, the partnership model of governance (and profit sharing) embodies several unique mechanisms that may mediate the ID-performance relationship. First, law-firm profitability is commonly measured by either profits per partner or profits per equity partner (Carlson, 2004; Denny, 2003, 2004), so anything that impacts on the number of partners relative to total profitability clearly may influence the ID-performance relationship. This would be the case, for example, if the internationalizing law firm uses fewer partners (or equity partners) to staff their foreign offices—which may be indicated by high repatriation costs, licensing difficulties, or time lags in filling these remote positions. This idea was behind the decision of Pillsbury Winthrop’s shift about 10% of the firm’s full-equity partners to salary-equity compensation when they merged with Pittman Shaw (Jones, 2006). Further, the use of non-equity partners needs to be studied, especially now that this category of partnership is recently generating critical interest in the legal profession (Griffiths, 2005; Wesemann, 2003).

It is noteworthy that the U.K. firms are significantly more global than the American firms (in both ID measures)—so one might think that the different effect of ID may result from their different stages of development in the global market. However, there are two arguments why we doubt this to be the case. First, if one begins with the n-shape of the (less internationalized) Americans and then the u-shape of the British, the resulting S-shape is the opposite of the Contractor et al. (2003) findings. Second, the average may be misleading, because the range of ID in U.S. firms is much broader than for the U.K. firms. Most of the U.S. firms have a relatively low to medium level of ID where the gains of internationalization seem to be positive; while only a small cluster are over-extended (ID > 60% lawyers abroad). Comparing the ranges (e.g., Figs. 3 and 4) it seems that our data do not include U.K. firms at the highest levels of ID (over 60%). Thus it may well be that the “stage 3” from the Contractor et al. (2003) S-shaped model of negative returns to highly internationalized firms may still apply to those U.K. firms if and when they internationalize to this level. Still, it may be informative to examine other variables that indicate experience in international diversification—like age of foreign offices—to check how international operations change in their performance over time. Similarly, future work should account for Nachum’s (2003) concept of firms that are more “active” and whose strategic actions thus affect their own performance.

Other future steps in this project will be to investigate some of the internal and external contingencies of performance in these firms. The use of leverage strategies and de-equitizing of partners seem to be crucial issues for attaining competitive partner profitability levels. Further, the difficulty in managing the partner–lawyer–client interfaces over geographically dispersed offices is a crucial capability clearly worthy of investigation. Finally, data on mode of international market entry—for example acquisition, Greenfield, or network alliance—will also allow us better to understand the processes by which firms cope with various strategic and contextual contingencies and successfully launch themselves beyond their native markets.
Limitations of this study include the limited data base and questions of generalizability. Because of the small sub-sample of only 13 U.K. firms, we should be guarded with the country-of-origin conclusions. Global law firms are more similar to other large knowledge-intensive professional service providers—like the large accounting, consulting investment banking, and engineering firms—but quite dissimilar on the one hand from the vast majority of professional service firms that are much smaller and less business-like (Cooper et al., 1996); and on the other hand from other service firms (for example, in retail, tourism, call centers, and education) where the partnership model is not used and lower-paid workers are employed. Future work should attempt to use longitudinal data that would give a better reading of the internationalization-performance relationship for firms sequentially entering foreign markets. Until then we should remember that, irrespective of the constant talk of globalization, the Atlantic Ocean that separates Europe and America still indicates a chasm with respect to several aspects of organizational management—apparently international diversification is one of these managerial aspects.

4.1. Implications for practice

Our theory and findings stress the crucial role of organizational capabilities in profitable internationalization. Service firms have to work constantly on learning about their clients’ needs and developing their capabilities to service those needs. For ID to be profitable, the contemporary knowledge intensive service firms needs to “cross-sell” new services to existing clients (Cranston, 2003; Harding, 2002; Jones, 2006; Maister, 1993). As a senior manager in a leading global law firm told us, cross-selling is about getting “more business from existing clients” and is a key driver of firm profitability. The fact that that several time zones may separate existing clients, existing staff, new staff, and prospective clients in the global firm certainly complicates issues. After the recent merger between Reed Smith and Richards Butler, the top managers were quick to stress cross-selling and client referrals (Grimshaw, 2006; Hoare, 2006). As part of this strategy a senior partner was “made responsible for ensuring cross-selling between the firms” (Grimshaw, 2006) and until the newly merged staff move into shared offices they will “move people around to get practice groups acquainted” (Hoare, 2006).

Successful firms use a combination of communication strategies (Tursi, 2005) and integrative mechanisms to encourage and enable cross-selling. For example, a leading global law firm, in partnership with a prominent Business School, has a series of week-long training programs for it top lawyers. One of the exercises consists of a cycle whereby each participant posts a sheet of paper listing the three of four things for which “I need help” followed by a rotation whereby they go around sticking yellow “I can help” stickers on the original sheets. Another exercise used in-house by the same firm is called “speed-dating for lawyers” that consists of brief, one-on-one sessions for people to describe their practice, their clients, the possible opportunities, and to encourage other participants to respond and to proffer their suggestions and opportunities. These integrating mechanisms are crucial exercises to enable lawyers—some from newly merged offices—to get to know each other in order to promote cross-selling of legal services.

Managers contemplating international diversification might still be hesitant about the upward and downward slopes of these internationalization-performance curves described in this paper. However, the apparent convergence in recent research results indicates some clearer realities relative to the context of the expanding international firm. First, firms seem to do better when internationalizing off a well-established resource foundation. So managers are advised to invest in physical infrastructure as well as human capital at home to strengthen the platform for foreign excursions. Also, the capabilities needed for successful IB are a function of learning and
experience, so it generally takes time to build domestic capabilities before successful internationalization can be anticipated. Further, there are indications that returns at the highest levels of internationalization are negative (although these figures are clearer for American than European firms) once again indicating the benefits of solidifying the firm’s presence in fewer markets if possible, rather than becoming over-extended. Finally, managers should be pleased that globalization is not only removing barriers to international business but also indicates a convergence in research results between capital-intensive and knowledge-intensive industry sectors. The manager’s job in this increasingly competitive marketplace continues to be a difficult one—but at least it seems that today’s research results are sending some clearer messages. This should be encouraging both for researchers to continue testing the performance implications of international diversification, as well as for managers to base their strategies on these studies.

References

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