

## **Reputation Networks and “Loose Linkages” between Reputation and Quality**

In this article a network model of the development of a suppliers' reputation in a market with quality uncertainty is presented. This model is based on communication and interaction processes within a market. It is shown that reputation is influenced by three factors: The customers experiences with a certain supplier, the diffusion of this information within the network "market", and customers using this information in their product evaluation process. The model suggests that reputation by no means presents automatic insurance against opportunism. High reputation may even prevent transactions under circumstances discussed here.

Recent empirical research suggests that in markets with quality uncertainty delivering bad quality and not fulfilling quality promises has an immediate and devastating effect on a supplier's reputation forcing him to continuously fulfilling quality promises (Herbig, Milewicz and Golden 1994). This paper challenges that suggestion based on theoretical considerations. These considerations are based on the concept of reputation developing within constituency networks which emerge through word-of-mouth communication. A reputation network model developed here shows that reputation networks may not possess the necessary propensities to allow for an immediate and strong quality-reputation relationship introducing “loose linkages” between reputation and quality.

### **Literature Overview**

When certain qualities of a product or service are observable only after the purchase the customers problem is to reduce quality uncertainty (Akerlof 1970). Company reputation has been widely recognized in literature as an instrument to that effect (e.g. Shapiro 1983, Fombrun/Shanley 1990, Bromley 1993, Fombrun 1996). Constituents such as customers, employees, owners, and regulators use this expectation when ex ante other information on quality of a company capabilities or outputs are not available (Carmichael 1984). Fombrun (1993) defines organizational reputation as certain salient evaluative characteristics that external observers ascribe to an organization. These characteristics reflect the past actions of that company (Kreps/Wilson 1982) and refer to the suppliers' future behavior. Observers can be any individual or institution interested in

validating a specific company or organization (Perrow 1961). Good reputation results from continuously fulfilling quality promises (Herbig, Milewicz and Golden 1994) and serves as a signal that this supplier will also deliver the promised quality to them after the contract is signed. In that case organizational reputation becomes an acquisitional asset: "Often this acquisitional potential is driven by the preferences that are created on the side of the customer, to a clientele which base their decisions to a large extent on the reputation of the business, with which they, on the basis of their own experiences or those of others, believe that it is safe to buy" (Gutenberg 1955, p. 200).

In a recent interdisciplinary review of reputation and related concepts such as brand image, prestige and goodwill Shenkar and Yuchtman-Yaar (1997) conclude that reputation is the result of a social mechanism in which constituencies "can be viewed as members of a network, situated at different social distances from each other, and excluding one or more members at each time" (Shenkar/Yuchtman-Yaar 1997, p. 1375). In such networks observers exchange their experience with a certain supplier which supports the building of reputation (Fombrun/Shanley 1990, Abrahamson/Fombrun 1994, Yoon/Guffrey/Kijewski 1993). This view is consistent with Berger's (1988) observation that reputation is the result of word-of-mouth communication (WOM) in customer networks.

Reputation networks enhance the power of reputation to reduce uncertainty beyond the supplier-customer dyad. Within that dyad a customer who feels that a certain supplier did not honor his promises can threaten him not to buy from this company again. The significance of this threat increases with the future demand of this customer. The economic value of a customer's future demand alone can be sufficient to encourage a supplier to act according to the agreement (and more). The incentive to keep to the agreement here results from the value of an ongoing business relationship with a certain customer: "Thus, one of the strongest incentives for honesty of a seller is his desire to obtain the continued patronage of his customer" (Telser 1980, p. 28). If the long term business relationship is of more value than the short term profit from opportunistic behavior, then the possibility of the customer breaking off the relationship will deter the supplier from opportunistic behavior.

Reputation as an instrument to reduce quality uncertainty reaches beyond this bilateral market mechanism. Customers can communicate perceived instances of opportunistic behavior ('broken promises') within the market to *other* customers, constituting reputation networks (Bromley 1993). As a result they may – or may not – damage the reputation of the supplier in the sense that other customers believe that they could be expo-

priated in a similar way, and so either totally or partly exclude him from further transactions as well. This mechanism was studied by Berger (1988) with regard to customer choice behavior and by Bulow and Rogoff (1989) and Cole and Kehoe (1996) with regard to the inclination of public debtors to service their debt. The debtor faces the problem that any failure in capital service for a creditor may prevent *other* potential creditors from giving or extending loans. In both cases we look at the effect of opportunistic behavior in its social context (Hill 1990) or – according to Granovetter (1985) – as a result of their “embeddedness” in social relationships. At the center of this context are the effects of broken promises within the network of future transactions partners.

From that perspective reputation is an instrument to reduce quality uncertainty, if a customer’s credible threat of shifting future demand *and* communicating opportunistic behavior within their networks promises more economic damage to the supplier than his immediate pay-off from reducing quality. Referring to networks Cole and Kehoe (1996) speak of “spillover” effects, and suggest that the value of reputation depends largely upon the size of the arena in which negative word-of-mouth takes place, and the number of possible transactions with active transaction partners in this arena. They show why the U.S. federal government honored a fisheries contract with Canada, which after signing turned out to be disadvantageous, in order to be able to secure cooperation with Japan on defense policy. From that they conclude: “(...) the benefits of maintaining a good relationship in one arena cannot be calculated simply by looking at that arena alone” (Cole and Kehoe 1996, p. 19).

Building on these ideas this study focuses on the building of reputation in networks of constituencies. The higher the potential damage to the suppliers’ reputation as a result of insufficient performance in all arenas concerned, the higher the value of reputation as insurance (Kreps and Wilson 1982). However, the ability of customers to sanction suppliers beyond the dyad depends upon the actual vulnerability of the supplier by bad quality WOM (Rao, Qu and Ruckert 1999). Several studies address this issue:

- Shapiro (1982) looks at time lags in the distribution of supplier-related performance information and their effect on the qualities suppliers actually deliver. He finds that equilibrium quality levels are lower with time lags than in perfect markets.
- Information reports are subject to individual perception (Weigelt/Camerer 1988, Herbig/Milewicz/Golden 1994) which may or may not induce another customer to sanction a supplier as a result of reports of bad quality.

- Podolny (1993) suggests that information diffusion is an imperfect (“stochastic”) process in which not every quality deficiency will be detected or communicated at the same rate.
- Geographic distance and the degree of diversification influences the probability of negative experience reports reaching other customers “because it is more costly to reach out and destroy every tentacle of a diversified firm” (Rao, Qu, and Ruekert 1999, p. 260).

These observations suggest that in the process of reputation building “informational efficiency plays a role” (Kreps 1990, p. 762). Consequently, a suppliers reputation for quality and the quality he actually delivers may only form “loose linkages” (Podolny 1993). Literature shows that the gravity of customer threats to damage a suppliers reputation by communicating bad quality is closely related to the characteristics of the process in which information on quality emanates from buyers, diffuses in customer networks and effects the behavior of other present and future customers of a certain supplier. In light of this conclusion the purpose of this paper is twofold: First, explicitly modeling the building of reputation as an information diffusion process in social networks as recommended by Fombrun and Shanley (1990). Second, based on that model investigating into the power of reputation as an instrument to reduce uncertainty. Although in literature many references to reputation networks can be found this attempt at a comprehensive model is novel. A systematic analysis of the origin of “loose linkages” between reputation and quality based on that model and theoretical and managerial implications follow.

### **Experience Diffusion, Networks and Reputation**

The emergence and change of reputation is closely linked to the diffusion of supplier-related information. Customers in a market can be interpreted as a communication network, whose members diffuse information relevant to customer decision making. In this sense reputation is the product of WOM (for WOM literature see, e.g.: Bearden and Etzel 1982, Richins 1983, Reingen and Kernan 1986, Brown and Reingen 1987, Bone 1992 and 1995, Blodgett, Granbois and Walters 1993, Frenzen and Nakamoto 1993, Koehler 1997). For reputation as the result of the diffusion of experiences within communication networks to emerge and effect supplier choice the following is required:

1. A customer (sender) communicates his or her experiences of the suppliers' services to other potential customers and, thus, supplies information relevant to reputation.

2. This information permeates in the market (information diffusion) and reaches other potential customers (receiver).
3. Experience reports influence the buying decisions of others customers. To do so the reported experiences must be viewed as relevant by the receivers and included in their buying decisions (information processing).

*Information Supply: Communication of Experience Reports in the Market*

The starting point of reputation-building interaction and communication processes are customers perceived results of transactions with a certain supplier. Experience is where reputation comes to life. The supply of information is therefore a necessary requirement for reputation to emerge (Bendall and Powers 1995). It can be assumed that perceived output insufficiency (the supplier has broken his promises) leads to the diffusion of negative experience and vice versa<sup>1</sup>. Empirical research shows that negative experience is a stronger motive to report than positive experience (Holmes and Lett 1977). What motivates ‘experienced’ customers to talk about their experiences with a certain supplier? Rational customers supply experience reports to the market if positive utility is associated with such reports. Thus, cost and benefits of the communication of experience reports must be assessed:

- The communication of negative experience reports is beneficial, if further opportunistic actions by the supplier during an ongoing transaction can be prevented. If the transaction is already completed, then supplying negative experience reports to the market is useless with regard to the results of that transaction. Beyond the bilateral supplier-customer relationship ‘ex post talking’ may induce other customers to provide relevant information for other buying decisions or – as game theory suggests – establishes a reputation of “being tough” (Milgrom and Roberts 1982) which causes other suppliers to refrain from opportunistic behavior, as they must also be fearful of suffering damage to their reputation (Weigelt and Camerer 1988).

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<sup>1</sup> Alternatively, there is no relationship between output quality and the essence of experience reports meaning that with regard to experience reports customers can act opportunistically. They could talk badly of suppliers to fellow customers, although there was no quality deficiency. This case will not be discussed here.

- Supplying experience reports to the market is costly if specific measures for this purpose are taken. Consequently, the diffusion of experience reports is limited to those reports which can be communicated efficiently.

For reports intended to damage reputation this presents a possible limitation. If benefits of reporting are nil and the costs of communication are positive, negative experience will not be reported. Exceptions are presented by customers who benefit from damaging the suppliers reputation alone. Other impediments to the supply of negative experience are negative attitudes of customers towards such action (Blodgett, Granbois and Walters 1993) and post-purchase dissonance reduction by lowering quality standards.

Beyond the influence of costs and benefits the diffusion of reputation damaging experience reports will increase with the perceived damage following output insufficiencies (Richins 1983), as well as with the amount of personal experience. The higher the damage from output insufficiency, the more important it is to deter future suppliers from opportunistic behavior. The amount of personal experience presents a necessary condition for the supply of information (Solomon 1986, Feick and Pierce 1987). Thus, an increase in experience leads to a higher supply of information. From empirical studies on the intensity of WOM communication we know that with increasing uncertainty customers actively search for information regarding the trustworthiness of suppliers (Mangold, Miller and Brockway 1999). Thus, customers themselves initiate the supply and diffusion of experience reports to the market.

#### *Information Diffusion: Diffusion of experience reports in the market*

Information diffusion is determined by the characteristics of the network (size, density) and its members (centrality). Frenzen and Nakamoto (1993) have studied the structure of markets as communication networks for the diffusion of information. They show that *network density* has a significant impact on the share of informed market members. The density of a network is a measure for the communication intensity in the entire network (Schenk 1984). Density can be defined as the ratio of the number of direct communication relationships between network members to the number of all possible communication relationships in a particular time period (Abrahamson and Fombrun 1994). The higher the density of the network, the quicker information is distributed through the system. In this sense we speak of close-knit and loose-knit networks with strong and weak communication relationships, respectively (Ben-Porah 1980). The speed of information diffusion is important for two reasons:

1. Over time experience becomes obsolete and irrelevant for buying decisions. Information on the ability and willingness of a supplier to perform can become obsolete with changes in product technology, staff, organization, production or logistics technology, etc. Thus, a constant (increasing) level of relevant experience "in the market" can only be achieved with a diffusion for new information as fast as (faster than) the rate of obsolescence or forgetting.
2. Only available information on a supplier is relevant to selection decisions. The faster information about suppliers diffuses the larger its effect on supplier choice

*Network size* influences the diffusion of experience reports as well. Larger networks tend to form clusters of highly connected participants, between whom communication intensity is low. To establish tight links to all network members would be inefficient in a large network. Consequently larger networks tend to show a lower density than smaller networks.

In some networks institutions exist which accelerate the information flow between network members.<sup>2</sup> Institutions such as chambers of commerce, purchasing cooperatives, virtual communities or industry journals induce or support direct and indirect communication links between members. Thus, *the degree of formal organization* influences the density of a network and hence the speed of diffusion of experience reports. In addition to that research by von Hippel (1987) and Schrader (1991) shows that information also flows through informal networks of individual market actors such as company employees. Industry rivals exchange information through informal networks if that exchange benefits both sides. The exchange of information on supplier performance is beneficial because it reduces quality uncertainty through functioning reputation mechanism. Thus, we can assume that experience reports will be exchanged through personal and informal networks.

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<sup>2</sup> Coleman et al. (1957) show this empirically with the diffusion of new drugs. Physicians in small towns talk directly to each other more often than doctors in larger towns do. In larger towns communication is conducted through institutions (such as hospitals) and impersonal means of communication (such as medical journals). Looking at the diffusion of innovations Schenk (1984, p. 289) notes: "In small and relatively closed-off systems the process of diffusion is sped up through people who are in the central position of an informal structure. They stimulate others to take up an innovation (...). People who have a central position within a communication network, and so who have the best chances to come into contact with those who have already gained experiences with the innovation, will take on a role of opinion leaders early one (...). People in the periphery or outside the network, so called "marginal" or "isolated" people, will somewhat later gain knowledge and judgements about an innovation due to their inferior integration, and so will only later (or even not at all) take up the innovation".

In addition to network-related determinants, the diffusion of experience reports is influenced by the *centrality* of an individual sender. Centrality describes the "degree of social integration or isolation" (Schenk 1984, p. 52) of individual network members. A party is central if it entertains direct communication relationships to many other network members. A central party has better chances to diffuse its own experience reports. Isolated customers – such as new entrants to the market or customers with infrequent demand – are in direct contact with only few other network members. Highly integrated customers are more important to a supplier, because their influence on reputation is higher. Hence, the value of reputation as insurance against opportunism is limited for isolated customers.

### *Information Processing: The Effect of Reputation*

A suppliers' reputation is based on individual perceptions and varies from customer to customer. As a result suppliers can have different reputations with different customers due to individual information processing (Shapiro 1983). What influence experience reports have on individual buying behavior is a question relating to the *effect* of reputation. The diffusion of experience reports is only a necessary condition for reputation to emerge. For this information to influence the selection among alternative suppliers it must be integrated into supplier evaluation. This integration requires the:

- *evaluation* of the perceived experience reports in terms to their *relevance* and the
- *aggregation* of (possibly) different relevant experience reports from third parties and own personal experiences with the supplier in question.

Only experience perceived to be relevant by customers will go to form their picture of the suppliers' reputation. The *relevance* of experience reports from other parties increases the:

- more similar the customers' situation and that of the party reporting from his own experience is,
- the larger the potential damage resulting from opportunistic behavior is,
- smaller the customers' personal experience with the supplier concerned is (Herr, Kardes and Kim 1991).
- the higher the credibility of the reporting party is.

Belk (1975) shows that WOM communication increases with decreasing personal experience with a certain buying problem. This means that the less we know the more uncertain we are and the more we search for experience reports from third parties to reduce that uncertainty. Increased search also occurs with a higher possible damage from output insufficiency because higher possible damage induces higher uncertainty. Experience reports collected in the market increase in relevance if receiver (buyer) and sender (reporting party) face similar buying problems. Similarity improves the receiver's ability to understand and evaluate the information at hand and allows for a better prediction of the supplier's performance.

The reporting party's credibility is a key determinant of the relevance of the information they supply, as the receiver can not verify this information without incurring costs. Credibility depends on the sender's level of expertise and trustworthiness (Engel, Blackwell and Miniard 1997). Expertise increases with the amount of experience with a certain supplier. To be a trustworthy sender the receiver must believe that the sender is not acting opportunistically. Bone (1995) shows that WOM communication specifically is viewed to be trustworthy, i.e. customers see each other as relevant information sources.

A particularly trustworthy customer is of foremost importance for a supplier seeking to enhance his reputation. With trustworthy customers Spremann (1985) speaks of a 'new contract' emerging between the transaction partners in which the supplier offers to the buyer a contract for further development of his reputation in the market. With this contract the supplier invests specifically in his customers. The specificity of this investment is due to the particular credibility of a customer with regard to information on the supplier's inclination to honor his promises. A customer reporting on his experiences with a certain supplier can be assumed to be more credible than the supplier himself or any third inexperienced party. The resulting quasi-rent associated with this specific investment lies in the difference of the economic value of the change of a supplier's reputation induced by reports of this customer compared to the next-best party reporting on the same transaction.

### **A Model of Reputation Building**

Fig. 2 presents a summary of our discussion with regard to the mechanism responsible for the emergence and change of reputation.

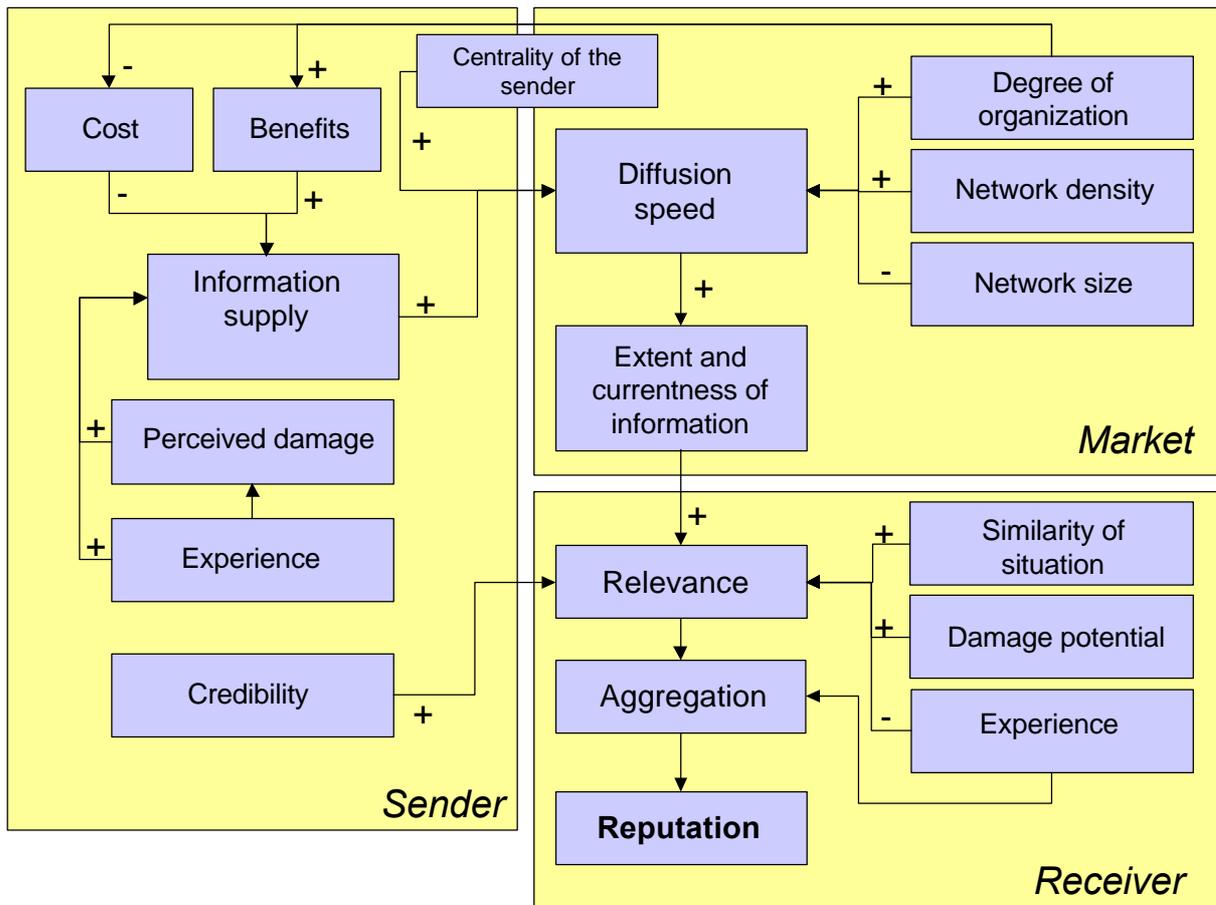


Fig. 2: Model of Reputation Building

A suppliers reputation is built upon customers experiences reports. In reality most suppliers do business with many customers resulting in a multitude of experience reports 'in the market'. In addition, a customer may have own experiences with the supplier in question. Thus, we must ask how this information is aggregated to an expectation concerning the suppliers ability and willingness to honor his promises. This question refers to the individual process of weighting and combining many informational elements to reputation. Referring to the weighting of external information, behavioral theory emphasizes the importance of conformity of supplied information and personal attitudes. High weighting of experience reports from third parties is more probable if they correspond to personal experiences.

Aggregation relates to the question how reputation as an individually developed expectation follows from own experience and experience reports from others. The case of contradictory experience reports is especially important. This is because corresponding experience reports present no problem to the formation of reputation. If everybody – including the sender himself – has the same experiences with a certain supplier there is

simply no need for an elaborate weighting and aggregation procedure. If, however, experience reports contradict each other, the receiver must decide how to aggregate this information. Analogous to attitude formation two different models are possible (for an overview on attitude formation see Eagly and Chaiken 1993):

1. Positive experience compensates negative experience, possibly within certain limits (multiattributive additive model).
2. Positive experience cannot compensate negative experience (non-additive model).

In the first case an individual evaluation function is needed, which weights positive and negative experience reports. From this evaluation function we can assess the extent to which extent positive experience must outweigh negative experience. Empirical research on the effect of WOM shows that negative WOM is assigned a greater weight than positive WOM in decision making (Richins 1983). Regardless of weights attributed to negative and positive reports, as long as compensation occurs a suppliers' reputation has limited value as insurance against opportunism. A customer expropriated by his supplier and consequently supplying negative experience to the market might find himself in a situation in which positive experience with the same supplier – reported by other customers – outweighs his report resulting in unchanged buying behavior. This problem will occur in cases in which the supplier enjoys a particularly high reputation in the sense of a high surplus of positive experience reports from the recent past. Reputation always protects against opportunistic behavior if negative experience reports can not be compensated. Then the amount of positive experience already 'in the market' is irrelevant.

Thus, compensatory aggregation of experience reports by customers lets the reputation mechanism fail if the number of customers reporting positive experience with a certain supplier is large enough. The threat to report negative experience in case of output insufficiencies may prove to be useless. Economic consequences in terms of reduced business will not follow as long as a 'critical mass' of negative information in the market is not achieved. If a single expropriated customer cannot reach that critical mass reputation as insurance is worthless. In that case high reputation can present an obstacle to transactions with quality uncertainty. This is because a single customer cannot change the general perception of this suppliers' integrity.

Compensatory aggregation of experience reports by customers may present an *incentive* to suppliers to behave opportunistically. Every supplier with a high surplus of favorable experience reports can limit the results of opportunistic action to the bilateral customer-supplier relationship. The only repercussion to fear is the discontinued patronage by an expropriated customer. A rational supplier will choose isolated customers or members of loose-knit networks for opportunistic action. Reputation milking (Shapiro 1982) will occur selectively and according to individual customer attributes.

The effectiveness of the reputation mechanism is also limited, if the supplier can reduce the effect of negative experience reports by either interfering with the diffusion of negative experience reports or reducing their impact on supplier evaluation. E.g., if the source of negative word-of-mouth is known the supplier can attack the credibility of the sender. Central actors within communication networks such as trade journals or prominent individuals can be pressured to stop the distribution of negative experience reports or encourage others not to pay attention.

### **Theoretical Implications**

Reputation as insurance against opportunism is discussed in literature as one of the reasons for the emergence of non-hierarchical institutional arrangements despite significant danger of opportunism. If the mechanism for the emergence and change of a suppliers' reputation works, it gives rise to a reputation contract which motivates the supplier to honor his promises. Consequently, a supplier who continuously honors his promises develops a good reputation. This high reputation presents an exogenously costly signal to customers, as it shows that in the past the supplier in question refrained from profiting from opportunistic action.

The model developed here suggests that the power of reputation to protect against opportunistic behavior is tied to various conditions. Empirical tests must show its validity and the hypotheses following from the model. The results of these tests notwithstanding, we must assume that reputation does not serve as automatic protection against quality uncertainty. Communication and interaction processes of market members steering the creation and change of reputation must not have the properties to establish an effective reputation contract. The power of reputation depends upon market-related, supplier-related and customer-related influences.

In order to reduce ex ante quality uncertainty it is crucial to what degree a particular customer can change or damage a supplier's reputation after the purchase. This seems

possible if this customer can diffuse information about this supply efficiently and quickly within the customer network. In addition, this information should have a long-term disadvantageous effect on the choice behavior of many other customers. If the customer reporting negative experiences is well connected within this network – in terms of being a central actor in the market – then preconditions are good. If he is particularly credible, then this further enlarges the effect of his experience reports. In this sense, reputation breaks down, if the market for reputation contracts is not perfect. Then hierarchical arrangements as safeguards against opportunism will prevail. Accordingly, Granovetter notes: "since networks of social relations penetrate irregularly and in differing degrees in different sectors of economic life, thus allowing for what we already know: distrust, opportunism, and disorder are by no means absent (Granovetter 1985, p. 491)."

In contrast to that Hill (1990) argues that in the long-term view notoriously opportunistic suppliers are forced to exit the market. He postulates that the invisible hand creates a long term equilibrium in which suppliers and customers execute transactions fulfilling their *ex ante* expectations. Hill suggests that cooperative behavior produces higher profits, which favors non-opportunistic actors in the long term. Hill's discussion is based on the assumption that suppliers typically play in various market arenas and that negative experience reports diffuse beyond the boundaries of the arena from which they originate. Thus, the effects of negative experience reports on the reputation of the supplier cannot be limited to individual markets. Hill argues that it is hard to believe that the reputation mechanism will fail in every market the supplier serves. The opportunist will therefore in the long term suffer from damage to reputation – possibly in markets in which he did not perform opportunistic acts. The only necessary condition for that to happen is at least one functioning reputation market. His conclusion is that opportunistic behavior in the long term can not be profit maximizing because losses will always occur.

Opportunism may not present a problem in the long-term view, as long as the assumptions of Hill (communication is always fast and efficient to accomplish) apply. The model developed here suggests a variety of possible reasons for the failure of reputation as insurance against opportunism. The more positive experience is reported, the higher transactions can be endangered if customers aggregate evidence with compensatory models or if the speed of information diffusion is low. Thus, high reputation can present an obstacle to transactions. The possibility of a failure of the reputation mechanism

shows that transactions with quality uncertainty can be at significant risk, despite good reputation of the supplier.

### **Managerial Implications**

New suppliers to a market with significant quality uncertainty intending to develop a favorable reputation can accelerate that process by performing high-quality transactions with highly-connected and credible customers. Incentives should be offered to encourage them to report their experience. Markets in which information diffusion is slow present a problem to reputation development in general. Suppliers can improve the degree of organization to accelerate diffusion by supporting institutions that provide reliable market information.

Market failure because of the failure of reputation networks is not in the interest of suppliers. The individual customers risk of receiving bad quality is assessable ex ante, as it depends – at least in part – upon their properties, which they can judge much better than suppliers' intentions. A customer may improve his position within the communication network anticipating the possibility of opportunistic behavior before the completion of the contract. Such actions adds credibility to the significance of his threat to report bad quality. To achieve that direct connections to central actors can be constituted. Alternatively, the degree of interaction among all customers of this supplier can be increased by creating information platforms or virtual communities. If such attempts to improve the position in a network are costly such cost become transaction costs. A supplier may support the creation of communication structures or the improvement of positions of single customers in order to avoid integration. Such support becomes a marketing instrument to lay the foundations for profitable transactions with potential customers.

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