ELSEVIER

Journal of Business Research 56 (2003) 767–775

JOURNAL OF BUSINESS RESEARCH

Social networks and the adverse selection problem in agency relationships

Robert Dahlstrom[a,*], Rhea Ingram[b]

[a]School of Management, University of Kentucky, 455-K Carol Martin Gatton College of Business and Economics Building, Lexington, KY 40506-0034, USA
[b]Middle Tennessee State University, Murfreesboro, TN, USA

Abstract

Agent selection is one of the most challenging decisions faced in the implementation of organizational strategy. Despite the central importance of this decision, limited research has addressed pre-contractual evaluation of agents. The purpose of this study is to illustrate how the examination of a potential partner's network of relationships alleviates costs associated with the adverse selection problem. Propositions that underscore the influence of network quality and structure on pre-contractual uncertainty are developed.

Keywords: Agency theory; Social networks

1. Introduction

Agency theory addresses situations in which one party (i.e., the principal) seeks to establish an exchange relationship with another party (i.e., the agent) to perform some organizational tasks on the principal's behalf. Principals and agents pursue cooperative relationships, yet they have differing goals and attitudes toward risk. Agency theory outlines factors that enable principal and agent to align incentives and establish efficient exchange relationships (Eisenhardt, 1989).

Adverse selection is an aspect of the agency problem that refers to information asymmetry between principal and agent (Akerlof, 1970). Trading partners that encounter asymmetrical information experience pre-contractual uncertainty that jeopardizes efforts to establish efficient exchange relationships. Prior research recognizes the potential for an agent's capabilities to be misrepresented, yet few studies identify means by which to overcome pre-contractual asymmetries. Harrison and Harrell (1993) address adverse selection, but they focus on previously established relationships. Coff (1997) also recognizes the need to manage information, yet his prescriptions to access competitive information or maintain internal labor markets are infeasible in many industries.

Relational contract theory (Macneil, 1980) characterizes the uncertainty that arises *before* establishing a relationship and the mechanisms employed to incorporate flexibility into contracts. Consistent with this perspective, Balakrishnan and Koza (1993) illustrate how joint ventures provide vehicles for learning about trading partners. Contracts that incorporate market and corporate governance mechanisms can also quell selection problems (Shane, 1996). Qualified agents view these hybrid arrangements as worthwhile, yet unqualified agents are reluctant to invest in hybrid contracts. These studies underscore the potential to alleviate uncertainty through contracts, but they are tacit with respect to the pre-contractual screening of agents. Moreover, many industries that employ hybrid contracts continue to experience substantial agency costs. Consequently, research that identifies other means to constrain adverse selection problems is needed.

The purpose of this study is to illustrate how examination of an agent's network of relationships influences the principal's costs of reducing pre-contractual uncertainty. Problems that occur before establishing the contractual arrangement lack formality and leave much of the exchange relationship unexplained (Granovetter, 1985) and opened to uncertainty (Williamson, 1985). In establishing agency relationships, one must weigh the costs associated with acquiring pre-contractual information against the losses associated with foregoing screening. Substantial research has addressed the liabilities incurred after an alliance is established, yet relatively little is known about the principal's a priori efforts to qualify agents. Nevertheless, the trade-off between pre- and post-contractual liabilities cannot be effectively assessed until the expenditures associated with both periods are identified. Our study seeks to augment research on the trade-off between pre- and post-contractual agency costs by identifying screening activities undertaken by principals.

* Corresponding author. Tel.: +1-859-257-6717; fax: +1-859-257-3577.

E-mail address: mkt341@pop.uky.edu (R. Dahlstrom).

0148-2963/03/$ – see front matter
doi:10.1016/S0148-2963(01)00261-2

We develop a theoretical framework relevant to situations in which an agent establishes an organization that is embedded in a network of interfirm relationships. These agency relationships are manifest in a variety of marketing settings such as franchises, advertising agencies, manufacturer representatives and contractors. The principal alleviates pre-contractual uncertainty through analysis of the prospective agent's existing relationships with organizations important to the distribution system. First, we suggest that the structure of an agent's network influences costs incurred to reduce uncertainty. Second, we characterize qualities of relationships within an agent's network that influence pre-contractual costs. Finally, we address interactions between structure and process and their influences on expenditures to reduce pre-contractual information asymmetries.

2. Conceptual framework

Adverse selection problems evolve from the principal's uncertainty regarding the agent's willingness and ability to perform tasks associated with system performance. For example, a machine tool producer has limited ability to assess whether a prospective representative has the ability to make cold calls and close sales. According to agency theory (Bergen et al., 1992), principals reduce adverse selection problems by screening agents before forging an alliance. Screening is performed via assessment of a broad spectrum of an agent's abilities gleaned from existing relationships as well as aptitudes to perform tasks endemic to an agent's success. Screening provides efficient solutions to adverse selection when the costs of obtaining information are low. When these costs are exorbitant, however, principals forego them for contracts that shift risk to the agent and mechanisms that monitor the agent's behavior. These policies reduce the principal's risk, yet they do not ensure that the agent is representing the principal in an acceptable manner (Ghoshal and Moran, 1996). Thus, research that examines the principal's pre-contractual costs is needed.

Our conceptual framework suggests that analysis of the agent's social network is one element of the principal's screening process. The parties to relational exchange engage in social interaction, and analysis of a potential partner's existing relationships provides information regarding the viability of an agreement with the partner (cf. Macneil, 1978; Iacobucci, 1996). The principal, by focusing on the agent's social network, reduces uncertainty before dedicating additional costly resources to an exchange. Evaluation of an agent's network of relationships augments the dyadic interaction between principal and agent (cf. Iacobucci and Zerrillo, 1996). The dyad remains the relevant level of analysis for decision making, yet the network in which the dyad is embedded affects the sentiments, behavior and performance of members of the dyad (Granovetter, 1973). As a means for illustrating the merits of network analysis to agent selection, we provide a brief overview of relevant network properties.

Networks have been defined in a variety of ways. Generally, networks are described as a set of two or more connected relationships (Cook and Emerson, 1978); some direct, others indirect. Thorelli (1986) refers to networks as consisting of nodes and links manifest in interaction between the nodes. For example, a sales representative has a strategic network of relationships. Individuals in the network serve as nodes with links between them characterized by the nature of the interaction between parties.

Analysts of networks must specify the *level of analysis* as well as the *limits on the network* (Knoke and Kuklinski, 1982). The definition of the problem prescribes the level of analysis, and this level ranges from individuals to clusters of organizations (Burt, 1980). When an organization is the focus of analysis, the set of relationships surrounding the firm is germane. This network includes the firms with which the organization has direct linkages as well as firms that are not directly linked to the focal organization (Aldrich and Whetten, 1981). By contrast, when an individual is the focus of analysis, the relevant network is the set of relationships the individual has with other persons. The problem definition also influences the size of the network under investigation. Bergen et al. (1992) suggest that principals know the nature of the tasks that agents must perform as well as the personal characteristics endemic to an agent's success. Similarly, the principal is likely to know the kinds of pre-contractual relationships that foreshadow successful agency agreements.

Our research focuses on pre-contractual costs incurred by a principal to evaluate a prospective agent in some predetermined context. These agency relationships are manifest in franchise agreements (Brickley and Dark, 1987) and manufacturer representative contracts (Anderson, 1985). Pre-contractual costs reflect expenditures associated with a principal's efforts to evaluate a prospective agent. These costs include agent observation, interviews, reference checks and other aptitude assessments. Principals lower pre-contractual costs by assessing the structure and character of relationships in an agent's personal network. The structure of the network describes the pattern of relationships that define an agent's position in a network, and the character of the network reflects the intensity of relationships between actors in a network (Burt, 1980). The information gained in an agent's network can be quantified and qualified. The structure of the network is more highly related to the quantity of available information, yet the nature of the network ties is more closely associated with the quality of information. Consider first how network structure influences pre-contractual costs.

2.1. Network structure and pre-contractual costs

Principals that apply a network perspective to address pre-contractual agency problems evaluate a prospective partner as a member of a local network. For example, suppose that a