Agent Opportunism and the Role of Company Culture: The Hudson's Bay and Royal African Companies Compared

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Concurrent with growth of long-distance trade in Britain in the seventeenth century was the use of the chartered company as the mechanism by which such trade with Africa, Asia, Russia, and North America was conducted. Indeed, these trading companies were analogs of modern multinationals with factories and agents located overseas. Because of their hierarchical structures, these companies faced potential principal/agent problems--they had to ensure that their overseas agents operated in the best interests of the company. The secondary literature is almost unanimous in its verdict that company agents were, in fact, the companies' worst enemies. Keith Davies, the historian of the Royal African Company, wrote that the company was bound to fail and did fail because "too much had to be left to the discretion of employees abroad who for the most part followed their own concerns to the detriment of the Company's" [7, p. 165]. This statement defines a principal/agent problem. E. E. Rich, the historian of the Hudson's Bay Company, in describing a letter of recall for one manager, wrote that "[Bayly] is to hand over all trade goods . . . and to 'bee assistante' to Lydall [new governor] in discovering and preventing private trade. Always private trade" [21, p. 101]. Again this is a statement about managerial opportunism.

That the secondary literature should focus on agent opportunism as a serious problem facing these early trading companies is easily understood when one considers the time and distances involved in communication. Communication between head office and managers abroad could take anywhere from three months to two years [4, p. 407]. In such a situation, local managers would have the ability to operate independently of the company and in their own self-interest. Yet despite this state of affairs, little archival work has been done to ascertain whether managers were the companies' worst enemies, whether these companies took steps to control managers, and whether they were successful in those endeavors. As a start in answering these questions, along with Stephen Nicholas, I examined the situation facing the Hudson's Bay Company. We showed that the Hudson's Bay Company did indeed try to control its overseas agents and argued that

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they did so successfully [5]. Currently, I am examining the strategies used by the Royal African Company and argue that while the company did try to control its agents, it was unsuccessful [3]. This paper, based on the more extensive documentation presented in the individual case studies, shows that though these two companies used similar strategies, the environment in which each operated and the resulting company culture led to opposite results.

Hudson's Bay and Royal African Company Trade

This section furnishes a context for the subsequent discussion of managerial strategies and company culture. (Detailed discussion is presented in [7, 23].) The Hudson's Bay Company (HBC) and the Royal African Company (RAC) received their royal charters within two years of one another, the HBC in 1670 and the RAC in 1672. The former company received the monopoly right to trade for furs within the drainage basin of Hudson Bay, while the RAC received the monopoly of the British slave trade along the west coast of Africa. Although each received monopoly privilege in theory, neither company had a monopoly in fact. Each faced competition from both European competitors and other British firms operating illegally outside the charter. Each company had its head office in London, and each conducted a barter trade in its trading region. The HBC exchanged European trade goods for furs around the coast of Hudson Bay. This was undertaken by salaried managers, whose job it was to trade with the Indians for the furs brought into the posts. The Indians brought in about sixteen different types of furs and exchanged them for a large range of trade goods. These furs then had to be baled and shipped back to London for sale at the company's fur auction. In turn, the head office had to purchase the required trade goods and get them shipped, along with the food and equipment necessary to support its personnel, during the time that Hudson Strait was open, a period of about six weeks [14, 18, 23].

The RAC conducted a barter trade along the west coast of Africa. This trade had two distinct parts. First, there was the triangular slave trade in which goods sent from England were exchanged for slaves. The slaves were shipped to the West Indies, where they were sold and the proceeds, either in bills of exchange or sugar, were sent to London. Second, there was the trade in commodities. Trade goods were exchanged for redwood (a dye), ivory, gold, wax, and malaguetta (a pepper), which were shipped directly to London for sale. Here again, the head office had to organize the purchase and shipping of trade goods and their subsequent sale [7, 13, 17, 24].

The basic problem facing the directors of both companies was ascertaining whether they were in fact receiving the maximum output for the trade goods sent. Because the actual trade was taking place in regions far removed from the head office, the companies were very vulnerable to opportunistic behavior by their managers. Thus, the companies had to devise strategies and solutions to guard against such behavior.

Opportunistic Behavior: Strategies and Solutions

The long-distance trades required that managers have some discretionary power; at the same time, the company had to ensure that such power was used to the best advantage of the company and not in the managers' self-interest. This is the "economics-of-agency" problem. Situations in which managers can operate in their own self-interest occur in the presence of asymmetrical information. There are essentially three different classes of asymmetrical information that are relevant to the issue facing the chartered companies and their managers: moral hazard with hidden action, moral hazard with hidden information, and adverse selection. The latter two are sometimes considered the same.

The head office's problems were related to its inability to see the effort level of its managers; it only knew the output it received. It then had to assess whether that amount was the maximum level of output. This is an example of moral hazard with hidden action; the head office knows something about the manager's ability but not his effort level, which may be either high or low. It is also possible that neither player knows the worker's ability, which is discovered only after the worker accepts a contract. If a worker knows his ability from the start, but the head office does not, then this is a problem of adverse selection. Indeed, the argument is sometimes made that only those people who intended to cheat to make their fortunes became managers in these chartered companies [16, chs 6-8].

In an ideal world it is always possible to devise an optimal contract--one that will call forth the required level of effort--but we have to examine actual contract structures and assess to what extent they might induce the "correct" response. To do so the theoretical literature suggests focusing on features of the compensation package. The first is the level of wages. The higher wages are, relative to what can be earned in other positions, the more costly it is for a worker to lose his job. This is the notion of an efficiency wage. Also important is the time path of wages. If a manager gets paid less than his marginal product early in his career but is rewarded with higher salaries later, there is also a high opportunity cost to losing one's job. Gratuities and bonuses can also be tied to output to increase the level of effort.

At the same time, unless a manager knows that he is likely to get caught and lose his job, he can still behave opportunistically. Thus, firms must monitor. Monitoring increases information flows by which the firm can assess performance. Monitoring can be done directly, by searching ships or reading letters, or it may be done indirectly, by generating accurate accounting procedures or by running tournaments among the managers. In a tournament, the output levels of individual managers are compared to the group as a whole, and managers are rewarded accordingly [16, pp. 167-68].

Thus, there are ways in which a firm can control the opportunistic conduct of its overseas managers; to do so, however, is not costless. Incentives, such as high salaries, gratuities or bonuses, and monitoring are all direct costs to the firm. What interests the firm, therefore, is the cost effectiveness of such measures. If it is very costly to monitor or if managers

can engage easily in private trade, then the level of incentives needed to reduce opportunistic behavior might be too high to be cost efficient. Thus firm profitability and success may be fairly sensitive to the exogenous environment [5 p. 859].

The nature of the interaction between the manager and firm is also potentially important. Possible theoretical solutions revolve around ideas of reputation and repetition. Therefore, in a multi-period game, the firm can encourage strategies that will result in the future growth of the firm [11]. Yet the nature of the interaction between the firm and manager can be influenced in a less obvious way. The firm can generate a company culture that, through the creation of an internalized set of mores among employees, leads to lower levels of cheating. This, in turn, means lower costs for the firm through lower salaries and lower monitoring levels.

Company Conduct and Culture: Employment Contracts and Monitoring

Within thirty years of receiving royal charters the RAC essentially had failed, while the HBC is still in existence. The failure of the RAC has been attributed largely to its inability to control managerial opportunism, while the success of the HBC has been attributed to the fact that it was a small company. Company success or failure, however, seems to be a function of working environment and company culture.

The employment contract is central to the firm's ability to attenuate opportunism and to call forth the relevant level of effort. A feature of employment contracts of this period not discussed in the theoretical literature is that all employees had to take an oath to work in the company's best interests. Although this was required by both the HBC and the RAC, neither relied on such oaths alone [5, p. 863; 23b].

The preceding section argued that to decrease cheating, wages should be high and/or rising over time. The quantitative evidence for the HBC and the RAC suggests that these companies followed such strategies. In a comparison with British wages, managers were paid high salaries, which tended to rise over the years of the contract [25]. Charles Bayly, the first governor at Hudson Bay, was initially given a salary of £50 per annum, but that was quickly raised to £200 per annum. A successor, John Nixon, had an initial salary of £100, which was raised to £200 in his second year of office [5 p. 862].

Salaries for those at the top of the RAC hierarchy were even higher. In 1676, the agent-general received £400, and by 1680 this had risen to close to £1000. This increase occurred because the company had made all personal trade illegal. In addition to the £600 increase, the agent-general was given a £200 gratuity at the end of the three-year contract *in lieu* of private trade. This would suggest that personal trade was financially rewarding. Those at the entry level of the managerial class received considerably lower but still high salaries, and those salaries increased over the years of the contract. In 1688, William Ward was hired as a factor for Cape Corso Castle at £40, £40, and £50, respectively, for each of his three years. Again, this is suggestive of an efficiency wage structure. Middle-level managers received £200 per annum

in 1677. These salaries were not negligible and suggest that losing one's job could be costly. In addition, both the HBC and the RAC provided room and board for their managers [7, p 252.].

Salary is not the only feature of the employment contract that can help reduce opportunism. There are other ways that companies can make it costly to lose one's job. Gratuities and bonuses are positive rewards for work effort, while bonds are monetary investments for good behavior. Such strategies make it more costly to be caught cheating. Interestingly, here the two companies diverge. The HBC was very generous with gratuities and bonuses. It believed that such policies increased work effort. In 1690 the company wrote that it had "Resolved on our parts not to faile of giveing encouragement to all whome wee find dilligent and active to promote our Interest" [5, p. 862; 19, p. 101]. In another letter of the same year, the company wrote to a Mr. Walsh that "you may see our Resolves to Leave noe merritt unrewarded for your further encouragement in the Preservation of our Rights and Encrease of the trade wee have voted you fifty pounds Gratuity, over and above your Fixed salary" [5, p. 862].

In the RAC's correspondence with its African managers, no such statements can be found. Over the period in question the company paid a gratuity to only one member of its African staff [23 g]. Instead, the RAC concentrated heavily on ensuring that all its employees were bonded. The HBC also used bonds but only for top-level managers. Each RAC employee was required to post a bond of roughly ten times his annual salary before he could be employed. The bonds generally could not be posted by one's family. The company preferred that a group of non-related people stand for the good conduct of the employee. Thus, factors earning £40 per annum had to post a bond of £400, whereas merchants placed bonds from £800 to £1500 [23c; 7 p. 256]. The RAC also paid close attention to those who stood bond. In a letter sent to Africa in 1690, the company wrote that "... we find now that we have by 400 pound Security from Mr. Ronan one of his security Mr. Gregory Wale being failed" [3 p. 18; 23c, 11th November 1690]. In response to a letter for promotion from Mr. Nightingale, the company wrote that the request "has occassioned us to looke into his security who we find to be his father in Holland if alive a man of small substance ... may be if he came home he will be able to settle his security better to our likeing". [3 p. 19; 23c, 18th September 1688]. Indeed, the company would not promote any person without that person increasing his bond. In the same letter to Mr. Nightingale, the directors stressed that they could not "preffer any Man to the greatest trust without a suitable Security and if you gett Friends here to strengthen you Security ... we shall be ready to bid you welcome" [3 p. 19]. Thus, not only do the choice of tools used by these two companies, differ (outside of salary), but the language used in the letters to express the company's relationship with its managers differs as well. I will argue in later sections that the differing choice of tools is not accidental. The companies' choices were constrained by the environment in which each operated.

It is clear that neither oaths, large salaries, nor large bonds are likely to perform well if a manager believes that he will not be caught. By cheating, the manager can increase his annual income. Thus a company must be able

to monitor its managers and then be seen to punish those who are caught cheating. Both companies monitored their managers directly and indirectly. A method of direct monitoring was to search ships for evidence of illegal trading. This meant that all ships leaving London for Africa or Hudson Bay as well as all returning ships were searched for any illegal merchandise. Both companies hired "waiters" to search vessels and paid them a percentage of the value of merchandise discovered. An entry in 1688 for the RAC documents that on searching the ship *Sarah Bonadventure* in the Thames estuary before it left for Africa, the waiters found "4 pecces Sayes, 15 pecces Perpetuanes, 3 boxes containing 10 gross of Knives and 1 barrell containing five gross of Knives over and above the Company's cargo" [23f]. A search on the *Unity* on its arrival in London found "by account of the waiters. Inwards there was brought home in the said ship (viz) 5 Negroe boyes, I Negroe girle, 46 Ellephants teeth, 1 cask wax 1 Elephants tooth..." [23f].

A major problem facing the RAC was the fact that not all of its trade was conducted between London and Africa. Slaves were shipped from Africa to the West Indies. The company asked its managers to search all ships on arrival in Africa, and the agents in the West Indies were required to search ships on arrival there. The obvious problem was one of collusion between manager and ship captain. Indeed, the company knew that many of its captains landed slaves illegally in the West Indies, but it was difficult either to catch them or to get direct evidence that they had done so. However, the charter party agreements for this period show that the company did try to make it more difficult for slaves to be smuggled into the West Indies. In particular, slaves had to be counted and recorded on boarding and then recounted on deck every fourteen days of the voyage. The log had to be signed by all officers of the crew, and all deaths had to be recorded on signed death certificates. But here again, collusion was a difficult problem, especially since a captain had the power to coerce the more junior members of the crew [3]. Even so, all ships were searched on arrival in the West Indies.

The HBC followd the same search procedure. The company minutes for 1679 report that "Charles Wilmott and Jeremy Griffith being appointed to goe on board the *John and Alexander* and to stay there to prevent all Frauds and Embezelments, tooke their Oathes so to doe and carried with them a Letter to Capt. Walker to receive them on board" [5 p. 865]. In fact, the HBC searched not only the ships but also all personal baggage and letters from Hudson Bay and sealed all legal consignments of trade goods before putting them on board ship.

None of this solved the underlying problem facing the head offices of both companies: how to tie managerial effort level to output. Direct monitoring, such as searching ships allowed the head office to discover if a manager was cheating, but both companies also needed to increase the amount of information they had about the trade and their managers. Each company required its managers to keep account books, journals, and ledgers. The companies sought to ensure that it received this information by laying down precise regulations and rigorous standards governing the way that the account books and journals were kept.

The HBC reproved its managers for not keeping letters "in paragraphs in the approved manner." In the letters sent from Hudson Bay, the first paragraph states what the directors "will find here enclosed . . ." [5, pp. 867-69]. Indeed, the HBC accounts were kept in a uniform manner by all managers. The RAC managers also were required to keep accounts and journals; in 1688, the head office even included the specific form to be used [3, pp. 22-24]. As an example, one set of instructions required the use of bills of lading. Instructions to Capt. Potloy, factor at Wiburne, required that he get four bills of lading from every ship: one to be sent to the factors in the West Indies, another to be sent to the head office by the same ship, a third to be sent to the head office by the following conveyance, and a fourth "it will be reason that you should keepe by you" [23c, 26th July 1687]. Although the level of compliance by RAC managers does not seem to have been as great as for HBC managers, both companies were able to use the accounting systems to increase the level of available information about the performance of any given manager. In essence, such information allowed the managers to run tournaments. The HBC seems to have done this to a greater extent than the RAC, generating terms of trade indices for each post. If an HBC post fell below a certain level, then the manager could be demoted or fired [5, pp. 870-71].

Obviously, it is not enough for companies to monitor their managers; they also have to be seen punishing those who were caught cheating. During the first decade of the RAC's operation, the agent-general was caught defrauding the company. He was recalled and replaced; his replacement also had to be replaced [3, p. 26]. There is no question that the company left in place managers that it knew to be acting fraudulently. The HBC also recalled managers for questioning at the head office. Not many managers were fired, but some were demoted to better learn the trade, as in the case of Richard Norton [5, p. 871].

From the preceding description it would appear that the HBC and RAC companies used methods that the theoretical literature suggests should reduce managerial misconduct. Both used high and rising salaries; one used gratuities, the other, bonds. Both monitored managerial activity and were seen to punish those who were caught. Yet the HBC was a successful company, while the RAC failed. As mentioned earlier, the failure of the RAC is laid on its inability to manage its managers. From the discussion laid out here, however, there is no question that the company not only attempted to manage its managers but also used methods consistent with the theoretical material on principal agent problems. The lack of success in this endeavor stems not so much from lack of effort but from efforts put in place that were never going to be cost efficient. The environment in which this company operated generated a situation particularly ill-suited to the problem it had to solve.

The African Environment and the Role of Company Culture

The necessity to use close monitoring or high salaries is lessened to the extent that the company can generate a company culture to which its

managers conform. Such an ethical system also helps alleviate problems of adverse selection, because the new manager is expected to behave in a particular way. The question is, how or under what circumstances is a company likely to generate such a company culture? Although this question cannot be answered specifically, the generation of such a system is related to the nature of the game being played between manager and firm and to the type of external environment in which the firm is operating. It may well be that the firm does not consciously decide on the type of culture generated; but, once it is generated, this culture will affect managerial behavior.

The literature on the HBC illustrates that that company successfully generated the notion of the HBC as family [5]. Attempts to create a "family environment" are particularly obvious during the French wars. The company wrote its chief agent that "for the better encouragement of your men in their Duty Wee doe hereby promise and assure you and them, that Wee will take Care by way of Pension for such of them as haveing behaved themselves with Courage and fidelity shalbe wounded and the Wives and Children of those whoe shall happen to bee killed in our Services" [5, p. 873]. All the correspondence is replete with positive encouragement. The large gratuities paid were often not tied to actual output, they were intended to promote future effort.

The ability to generate this family environment was further enhanced by the way the company chose its managers. In its early years, the company either hired managers in England or promoted people through the ranks. Although these people could be very good managers and traders, the head office believed that performance could be better. To this end, the company started an apprentice managerial class made up of young boys, taken from institutions such as Christ's College. These "blue coat" boys usually between the ages of fourteen and twenty one, learned the required fur trade skills and accounting procedures. Most of these boys had no immediate family in England, and the fur trading skills they learned were not easily transferable. Thus, not only did the company solve its potential adverse selection problem, but it also generated a group who were likely to remain with the company for a long time. In game-theoretic terms, the company was looking at a repeated game, and for both sides reputation was clearly important. With its gratuities and bonuses, the head office was investing in a future relationship between the directors and the agents [5, pp. 872-74].

The RAC situation was very different. While the HBC was playing a repeated game, the RAC was engaged in a non-repeated one. Managers were hired for a three-year term; only the very occasional manager signed up for a second term. This made it difficult for the company to invest in the future. Gratuities and bonuses would not lead to future pay-offs for that agent.

Two basic problems faced the RAC in its attempt to generate a positive feedback relationship with its managers. The first related to the fact that the coast of Africa was a very unhealthy place for Europeans. The mortality rate for managers was high. The Company letters or minutes report such statements as "the death of three Agents successively at the Fort in Gambia" or "the long illness of Agent Hodgkin" [3 p. 19]. In fact, using the *Lists of Living and the Dead*, Davies estimated that over 60% of those who first landed

in Africa were dead by the end of the first year, although the death rate declined substantially thereafter [12 ch. 4]. In these circumstances a manager was unlikely to make a long-term commitment to the firm. Another feature of this unhealthy environment was the ambiguity concerning the amount of effort expect for any given level of salary. The head office could have been expecting a given amount of effort, while sickly managers might only have been able to operate at a lower level of productivity. Such a difference in expectations would tend to generate a more confrontational relationship between the manager and the head office and may in part explain the lack of any positive reinforcement by the company.

The second factor lies in the nature of the outside environment. The HBC trading area was relatively closed. Even when the managers had gained expertise, the firm was practically the only place where they could use it. The managers of the RAC operated within a radically different environment. Any RAC agent operating in Africa was in daily contact with traders of other nations and with interlopers from Britain. A letter written in 1684 states that interlopers from both England and the plantations "not only spoil the trade but Corrupt our own Servants..."[3 p. 29]. Cheating was easy. Yet the problem facing the RAC was even worse than the availability of opportunity to cheat. Because of the openness of the environment, managers were making contacts as well as gaining experience that would be useful outside the firm structure. They could work for themselves, which made managers less interested in their future with the firm. Given the rapid turnover, the lack of positive reinforcement, and the ease with which outside occupation could be obtained, there was little that bound the manager to the firm.

Conclusion

The failure of the RAC and the success of the HBC do not stem from lack of effort to control managers. Both companies monitored their workers and used high salaries, bonds, and oaths to reinforce required behavior. Yet the environment in which the RAC operated proved inadequate. The company paid high salaries, but it could not meet the alternatives available. The company monitored, but firing as a punishment did not have a large impact if former employees could then work for themselves. The company did not use strategies that would enhance the future growth of the firm because of the non-repeated nature of the game. The RAC was a company for whom the costs of agency were too high to make a hierarchical structure work.

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