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Abstract

The City of Glasgow Bank failure in 1878, which led to large numbers of shareholders becoming insolvent, generated great public concern about their plight, and led directly to the 1879 Companies Act, which paved the way for the adoption of limited liability for *all* shareholders. In this paper, we focus on the question of why the opportunity was *not* taken to distinguish between the appropriate liability for 'insiders,' i.e. those with direct access to information and power over decisions, as contrasted with 'outsiders.' We record that such issues were raised and discussed at the time, and we report why proposals for any such graded liability were turned down. We argue that the reasons for rejecting graded liability for insiders were overstated, both then and subsequently. While we believe that the case for such graded liability needs reconsideration, it does remain a complex matter, as discussed in Section 4.

1 Introduction

The City of Glasgow Bank failure in October 1878 was an important event in the history of banking regulation and capitalism. The plight suffered by many of its 1,819 shareholders liable in an unlimited way for the bank's losses led to a significant change in company legislation – the 1879 Companies Act – which laid the groundwork for banks' widespread adoption, decades later, of pure limited liability.[2]

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[2] The Act in fact gave a choice to banks between unlimited liability for all, limited liability for all, and 'reserve liability' for all. By introducing the halfway-house concept of 'reserve liability,' a form of extended liability, the Act sought to incentivise more banks to do away with unlimited liability and adopt more limited forms of liability. See Section 3.

Pure limited liability – as 'limited liability' is defined today – entails that when a bank makes losses, shareholders, including senior bank executives, can be asked to make up for those losses *only* up to the amount they initially invested in the bank, which contrasts with their potentially *unlimited* upside gains. If, in the end, this limited contribution amount is insufficient to cover total losses, some of the bank's creditors, another bank, or indeed taxpayers may be asked to foot the bill. By incentivising the strict restriction of shareholder liability, the 1879 Act contributed to the advent of the modern era of British banking, one in which banks had no trouble attracting large numbers of shareholders now relieved of a heavy burden.

Yet this era was also one in which senior executives, like the other shareholders, gradually lost a major stake in banks' survival, with the costs of bank failure shifting progressively to society. Despite recent efforts to reverse that trend through better resolution practices (Philippon and Salord 2017), issues of moral hazard and a sense of injustice among taxpayers persist to this day (see Admati, Conti-Brown and Pfleiderer 2012; Greenwood et al. 2017; and Cohan 2017).[3]

In this paper, we examine the causes of the failure of the City of Glasgow Bank, as well as the debates that took place in its aftermath, focusing specifically on the allocation of information and control among bankers and shareholders. We argue that the 1879 Act, like many Company Acts before and after, had little regard for either, missing an opportunity for more thoughtful reform. Following Goodhart and Lastra (2020), we suggest that its one-size-fits-all approach to liability, one that applied *equally* to all shareholders in the bank, including senior management, was flawed, and was not justified by the facts around the failure itself. Rather than limit all shareholders' liability equally, as British banking law has persistently done, we propose that those within the bank's management with more

[3] Up to 2008, shareholders' liability had eroded so much that some might describe it as less than purely limited, with most of the bailout burden being born by taxpayers. Modern, post-2008 financial crisis resolution frameworks plan to make shareholders and 'bail-inable' creditors bear some of the cost of the failure or merger. However, in these frameworks all shareholders' stake, including that of executives, does not extend beyond pure limited liability (Bank of England 2019), so that the asymmetry between limited losses and unlimited gain potential remains.

information and control have *greater* liability. This alternative framework meets concerns about both the ability to attract shareholders, by strictly limiting their liability, and keeping senior executives accountable, by extending theirs. A similar proposal was in fact made by some commentators at the time, and shelved, we argue, for insufficient reasons.

The plight of the great majority of the City of Glasgow Bank shareholders led to understandably critical reactions. The losses of the bank were so large (more than six times its capital) that many of the bank's shareholders, under the rules of unlimited liability, became insolvent.[4] Many, especially in the press, exaggerated the damage caused by portraying shareholders as men and women of modest means thrown into poverty overnight, when in fact most were relatively wealthy individuals, which enabled depositors to be repaid in full (Acheson and Turner 2008; Lee 2012; Turner 2014). Nevertheless, public outrage also came from the fact that shareholders had been left out of some of the key decisions made by the executive directors over 1876-8. In the eyes of many observers, they could neither have had the adequate information nor the adequate amount of control over banking operations needed to be rightfully held responsible for the bank's failure. The public's call for limiting shareholders' liability was therefore justifiable.

But what about senior executives? The executive directors, for instance, were presumably those with both the adequate information and necessary control powers to make banking decisions. Why didn't the 1879 Act differentiate between their liability and that of the other shareholders? Senior managers' liability was not a central part of the debate, which focused more on the obvious and popularly decried plight of the latter. This may have been, by itself, part of the problem. But the question was asked by some. There was, at the time, an assumption that extensive forms of liability would attract 'men of straw,' men of modest means, devoid of talent and with little to make depositors good, providing further justification for limited liability. This assumption was based on erroneous grounds

[4] Losses amounted to £6,190,983, 11s. 3d. (Official List of Shareholders 1878, p. 7).

(Turner 2008, 2014). Nevertheless, it was widely held and was also applied to directors. This argument can still be heard today.

Yet limiting senior managers' liability in the same restricted way as the mass of shareholders could come with sizeable costs. First, it could introduce an incentive problem whereby senior executives with little to lose on the downside, but unlimited upside potential might be tempted to take excessive risks. This moral hazard issue was recognised either explicitly or, more often, implicitly, and the remedy was found in regular audits. As long as a bank was regularly examined by external auditors who would check the truthfulness of published balance sheets, the argument went, depositors' funds would be safe. The 1879 legislation therefore shifted the onus of good banking practice from bank insiders to auditors and regulators, just as US legislation would do some fifty years later.[5] Second, limiting liability significantly increased the potential for injustice if it meant that senior executives lost little during taxpayer-funded bailouts and even, some might argue, bail-ins.[6]

In this paper, we first examine the City of Glasgow Bank failure in more detail thanks to the extensive material that has been preserved in relation to it, including the verbatim account of the directors' trial in 1879. A central point of focus in this analysis is the allocation of information about, and control of, the bank's operations in the years preceding the failure among the directors and other shareholders (Section 2). We show that, then as now, the size of the shareholder pool brought sizeable capital but precluded shareholders' access to key information and reduced their agency in the bank. The bank's shareholders could be considered 'outsiders,' like most of today's bank shareholders. In contrast, the executive

[5] See White (2011).

[6] 'Bail-in' is a framework that is now hoped to become the standard resolution tool among regulatory institutions. While bailout entails that losses are almost entirely born by taxpayers, bail-in ensures that shareholders contribute (in a purely limited way), as well as some creditors by order of seniority (e.g. through CoCos, or contingent convertible bonds). Given shareholders' limited liability, the possibility that taxpayers' money may be needed in a major failure cannot be excluded. Regulators have also introduced vesting periods and clawbacks for executives, but these are only applied in case of explicit wrongdoing (Bank of England 2019; Liu, Liu and Yin 2023; Ross 2020).

directors all had information and control in a way that would qualify them as 'insiders.'[7] In this sense, from a moral hazard point of view as well as from the point of view of justice, limiting most shareholders' liability made sense, while limiting that of senior executives in the same way did not. This helps build the case for more graded forms of liability.

We then explore the debates that followed the bank's failure to understand and critique the arguments that gained traction and eventually led to the passage of the 1879 Companies Act facilitating the equal limitation of all shareholders' liability, including that of executives (Section 3). To this end we pore over pamphlets, newspaper articles, parliamentary speeches, and parliamentary debates. Many of the arguments put forward on various sides had already been made in the decades preceding the crisis, and the move towards equal forms of limited liability had been a process long in the making. But the bank's failure gave them extra weight and urgency.

The main argument against requiring more extensive liability for senior management was the same as that regarding other shareholders: that it would repel wealthy and skilled men from the profession. In fact, this argument was partly misconceived. Unlimited banks had no trouble attracting a large pool of wealthy and skilled individuals thanks to the greater trust they inspired, which widened business opportunities and gave a greater prospect of stability. As we will see, there are good reasons to believe that this would remain partly true today, especially with the rise of social responsibility as an integral objective of corporate agendas. Nevertheless, the issue of job attractiveness must be taken seriously in a hyper-competitive environment.

In Section 4, we will see that graded corporate forms have existed in the past (and indeed continue to exist) in continental Europe, co-existing with limited corporate forms. To ensure persistent job attractiveness, these graded liability forms have

[7] There were also non-executive directors, who would be better described as 'outsiders.' See Sections 2 and 4.

all compensated senior management in one way or another – albeit not always in a sustainable way. We end the paper by suggesting practical ways of doing this, following three core principles: that even extensive liability should remain defined (such as double or triple); that it be compensated financially; and that a Court of Appeal be set up for contentious cases. Other important practical details are also discussed. While we refrain from drawing any firm conclusions about the exact shape of optimal total executive remuneration, we end by summarising how the City of Glasgow Bank failure and its parliamentary aftermath provide a strong case for liability reform.[8]

2 Information and control at the City of Glasgow Bank

Let us start with some basic facts. The City of Glasgow Bank was one of the largest Scottish banks, incorporated in 1839. It had 133 branches at the time of failure. All 1,819 share owners had unlimited liability, meaning that in case of losses they could be called for an unlimited multiple (initially equal across shareholders) of their subscribed capital (Official List of Shareholders 1878).[9] It had an original paid-up capital of £1 million, and its minimum share denomination was £100. From as early as 1873, but especially from 1876 onwards, the bank, under the leadership of Robert Stronach, started concentrating a great part of its assets in loans to individuals and companies in liquidation or close to it, instead of responding to the need to close those accounts and potentially close the bank itself early on before further losses were made.[10] In the end, the bank closed with £6.2

[8] Many others have advocated for some form of liability reform, often based on historical experience. See for example Macey and Miller (1992); White (2011); Conti-Brown (2012); Haldane (2015); Koudijs, Salisbury and Sran (2018); Aldunate et a. (2021); Edmans et al. (2012); Mitchener and Richardson (2013); Schwarcz (2017); Huertas (2019); Salter, Veetil and White (2016); and Bogle et al. (2024). For more neutral or contrary stance, see Button et al. (2015) and Kenny and Ögren (2021).

[9] Their liability was 'joint and several,' whereby if some shareholders could not pay their portion, the others must compensate and pay a greater multiple of their initial investment. This is to be contrasted with *pro rata* liability, where liability cannot go above a pre-agreed limit. 'Subscribed' capital was usually above capital 'paid up' by the shareholder, who could then be called in, in the normal course of business, for more capital up to the subscribed amount (*Banker's Magazine and Statistical Register* 1879, vol 14, issue 2, p. 99). See Section 3 for more detail.

[10] Some of these loans were made to companies that had connections with one or two directors. But none of the directors were found guilty of borrowing from the bank for personal gain.

million in losses, and liquidators eventually called upon shareholders for 27.5 times the par value of their shares. Only 254 shareholders remained solvent after liquidation (Wallace 1905). The seven executive directors were tried and sentenced to several months in prison.

The bank's corporate form was the most common one at the time in Britain, one which followed the original Scottish model. From early on, the Scots had realised that small partnerships, in which all partners had managing power and unlimited liability, had both an advantage and a drawback. The advantage was that, to borrow Goodhart and Lastra's (2020) expression, liability 'matched power:' partners had equally significant skin in the game and power to act, which was viewed as fair to all involved.[11] The problem was one related to size: partnerships could not expand significantly without spreading managing power over many heads and thus losing efficiency. In turn, size restrictions reduced access to capital, asset diversification and raised the probability of failure, as illustrated in the 1825 English banking crisis (Pressnell 1956, p. 226).

The Scots had thus devised an alternative corporate form which allowed for bank owners to be as numerous as necessary, thanks to a transfer of controlling power to a small set of managing partners. This separation of ownership (by numerous shareholders) and control (by senior executives) was a significant innovation as it allowed firms to raise unprecedented amounts of capital and expand. The numerous 'outsider' shareholders were now simply 'sleeping partners,' while control was retained in the hands of a few managing directors (Acheson, Hickson and Turner 2011a; Turner 2009). In the process however, the original advantage of small partnerships was lost. By retaining unlimited liability, sleeping partners risked their personal wealth despite having lost much control in the bank's doings. Power and liability had become disconnected.

[11] The fact that control is also matched by access to information is also key. See Fama and Jensen (1983).

In spite of this disconnect, this model was adopted in England with the passage of the English and Irish Co-partnership Acts of 1826, as the advantages relative to small partnerships were more obvious than the downsides. Not only could banks now expand, but they could also convince uninsured depositors that their money was safe, with so many unlimited shareholders (Pressnell 1956).[12] There might have been a danger that unlimited shareholders sold their shares to men of low wealth, especially with rising insolvency risk, but managing boards had the power to vet share transfers, and the law ensured that owners remained liable after a transfer for three years anyway (one year after 1862). The ability to attract depositors was a major reason why, despite limited liability being allowed for banks from 1858 onwards, by 1875 most British banks had still chosen unlimited liability (Anderson and Cottrell 1974).[13]

But the disconnect between power and liability remained. This is nowhere more apparent than at the City of Glasgow Bank. All unlimited shareholders except for the shareholding directors were kept out of key decisions made by the bank. Their power mainly consisted in the ability to vote for the appointment of directors at the Annual General Meeting (n.a. 1859b). Most of them were from relatively wealthy backgrounds: lawyers, medical doctors, farm owners and merchants (Acheson and Turner 2008). They had bought or inherited their shares with confidence and believed that the appointment of what they thought of as respectable directors was enough to keep the bank on the right path. This was true even of the large shareholders, such as Robert Brown, a Glaswegian merchant who owned £5,000 in shares, or James McGowan, a manufacturer with £5,500. The only information they had access to was that provided at the Annual General Meeting, especially in the form of the annual published balance sheet prepared by

[12] Whether the bank incorporated as a partnership or as a joint-stock company made no difference from a liability point of view.

[13] The Companies Act 1862 confirmed that banks could incorporate as limited liability joint stock companies. It also removed the £100 floor on the minimum denomination of shares and meant that unlimited shareholders remained liable for one year after transferring their shares. Previously unlimited-liability banks were allowed to re-incorporate as limited liability banks under this Act, but once incorporated under this Act were not allowed to change their contract (Acheson and Turner 2008). In 1875 Great Britain and Ireland, there were still 82 unlimited banks, against 52 limited ones (Dun 1876).

the directors (Wallace 1905, pp. 370-408). The latter was provided as part of the 'Report of the Directors,' which initially also included a very succinct verbal summary of how the bank had fared over the previous year, but from 1864 onwards even did away with that (n.a. 1864).

On the other hand, the seven 'executive' directors were under the same liability regime as the other shareholders but benefited from a very different position. By virtue of their original contract, they had the right, if not the duty, to examine the bank's books at any time.[14] They could also make important investment decisions without waiting to consult the other shareholders at the annual meeting. (There were also four non-executive directors who did not have the same rights and duties, formally or informally defined, and in consequence were not tried).[15]

Some might argue that the shareholders would have known about the bad loan decisions had the executive directors not broken the law. Indeed, all seven of them were convicted of issuing balance sheets 'knowing them to be false' at the annual meetings in 1876, 1877 and 1878. Two of them, the managing (or chief) director Robert Stronach, and Lewis Potter, were found guilty of actively falsifying the balance sheets and incurred a longer prison sentence.[16] The balance sheets were falsified in obvious ways, for instance by subtracting loan items from the loan categories and adding them to safe security categories. However, one can doubt whether more truthful balance sheets would have revealed all the management issues at the bank. Even today there are more subtle, legal ways of overstating asset values to shareholders. In general, it may be said that most shareholders within joint-stock companies have been and continue to be 'outsiders,' by design. Already in 1856, Walter Bagehot, who later became *The Economist*'s editor,

[14] Only the managing director had the actual duty of examining the books closely (Wallace 1905, pp. 373, 387-9).
[15] The seven tried directors would be called today the 'executive' directors; at the time there were called the 'Edinburgh Board of Directors,' and included Robert Stronach, Lewis Potter, Robert Salmond, Henry Inglis, John Innes Wright, William Taylor and John Stewart. They are to be contrasted with the 'Glasgow Board of Directors,' which included John Gillespie, Robert Craig and A. F. Sommerville, and did not actively participate in the management of the bank, except for Henry Inglis since he was also part of the Edinburgh Board (Wallace 1905, p. 9).
[16] Issuing balance sheets knowing them to be false was a criminal offence, entailing punishment (for example through a prison sentence) rather than just financial compensation.

pointed out that 'very few shareholders can know anything of the management of the concern… only very few persons can be really aware how things are going on' (St John-Stevas 1978, vol. 9, pp. 308, 312).

In a sense, therefore, one can understand the injustice felt by many shareholders in the face of the outsized calls for capital during liquidation. Depositors, whom everyone readily accepted did not have the information necessary nor the power to monitor their bank, were due to be paid back in full. But did the vast majority of shareholders have much more information and control than depositors? Following the City of Glasgow Bank failure, there was a widespread realisation that they did not, and that even if the law had been abided to and truthful balance sheets published, they might not have had all the information or control necessary to significantly alter the course of the bank's operations. A shareholder signing 'One Who Will Be Properly Ruined' wrote to the *Glasgow Herald* on 12 November 1878: 'We, the miserably ruined shareholders of the City of Glasgow Bank… feel… that surely we will not be allowed to be entirely beggared, through the acts of a coterie of men, whose doings, *had we but known of*, would have been stopped long ago [emphasis added].' As far as Quebec the press frequently referred to the unlucky shareholder 'whose management he has little or no control over' (*Quebec Daily Telegraph*, 30 Sept 1879).[17]

Many, on the other hand, perceived as fair that the executive directors were not only prosecuted, but also made to lose significant amounts through unlimited liability. The seven directors of the City of Glasgow Bank had been contractually required to hold a minimum of nine shares for a total of £900 each.[18] This was designed to reduce moral hazard by ensuring that they, too, had skin in the game. The evidence shows that each of the seven directors did hold at least £900 in stock at the time of the trial (n.a., 1879, pp. 3-4). Selling this stock would have meant losing the directorship. Even in the case where they would have preferred to step

[17] This article was titled 'Limited Liability.'
[18] This had been decided at the 1859 Annual General Meeting (n.a. 1859b, p. 2).

down as director, they would have remained liable for their shares after one year of doing so, which provided a disincentive for selling.

And yet, a basic argument against extending senior executives' liability, which was not formulated at the time, would go something like this. Given how much the City of Glasgow Bank's directors had to lose financially, judicially, and therefore reputationally, the fact that they acted illegally and in ways that seriously compromised the bank's survival shows that no amount of liability would have prevented them from straying. This line of reasoning undermines the argument for extended liability based on moral hazard for senior management (but not the argument based on social justice).

Granted, in many cases the threat of future losses will not prevent excessive risk-taking due to a form of irrational behaviour often referred to as 'gambling-for-resurrection' that can make bank executives invest in unprofitable projects against their own interest (Rochet 2009; see also Baghestanian and Massenot 2015). However, from a theoretical point of view there is no reason why, on average, rational senior managers should not respond to incentives such as greater skin in the game. For this reason, as well as for social justice considerations, the case for extending senior executives' liability remains strong.

In addition, there may be specific reasons why the threat of financial liability was reduced for some of the City of Glasgow Bank's directors, which may have played some role in their behaviour. Four of the seven directors had become heavily indebted to the bank by the time of the trial. Although their personal wealth is unknown at this point, this fact may reveal that, at least in the couple of years preceding failure, they owned little and did not have much to lose, which may have increased their incentives to gamble for resurrection.[19] It also appears that at least three of them held larger amounts of stock earlier on but sold in the years

[19] These are: John Stewart (overdrawn to £11,521), William Taylor (overdrawn to £73,460), John Innes Wright (overdrawn to £2,746), and Henry Inglis (overdrawn to £44,615) (n.a. 1879). Note that there is unfortunately no information about salary.

preceding the failure, leading them to own only the minimum required amount.[20] This may be a sign that the set minimum was too low. Finally, two of the directors had also been directors or partners in enterprises that were connected to some of the firms that were deeply in trouble and to whom the bank was continuing to lend. This may have disincentivised them from resolving to close the relevant accounts.[21]

In Sections 3 and 4, we come back to these deficiencies and suggest that specific safeguards need to be put in place to prevent this kind of situation from arising.

3 Arguments against extending senior executives' liability, leading to the 1879 Act

The failure of City of Glasgow Bank led not only to public outrage, but also to a relatively well-structured debate in the press, across pamphlets and within Parliament about the proper extent of shareholder liability. This debate eventually led to the passage of the 1879 Companies Act on 13 August 1879. This Act did not impose pure limited liability. In many ways, it was not so different from the 1862 Act, which had already given a choice to banks between unlimited and limited liability. What was new in this 1879 Act was the added option of 'reserve liability.' This addition was important in that, as a halfway house between unlimited and limited liability, it led to better acceptance of the concept of limited forms of liability, thereby facilitating the move away from unlimited liability.

[20] The facts are as follows. Lewis Potter held £10,000 in stock when he first became director. This was reduced in 1871 and again in 1874, to yield £1,200 at trial time. Robert Salmond owned £2,200 in 1873, which he had reduced to £1,200 by the time of the trial. Finally, John Stewart had owned £6,000 in 1874. He sold £5,000 in January 1878, leaving him with £1,000 at trial time (n.a. 1879, pp. 3-4). Note however that, as it could not be proved that the issuance of false balance sheets was aimed at the overdrawing of accounts for personal gain, the charge of overdrawing of accounts for personal gain was dropped (Wallace 1905, pp. 370-408).

[21] Lewis Potter had two firms in the merchant shipping business which were connected to the two ailing firms to whom the bank was continuing to lend, one owned by John Fleming and the other one owned by James Nicol Fleming, brother of the latter. John Innes Wright's firm, who were East India merchants, was connected to James Nicol Fleming's (Wallace 1905, p. 205). Despite this, the directors were not charged with the overdrawing of accounts of personal gain (Wallace 1905, pp. 370-408).

This legislation had positives, and its impact should not be overstated. As stated earlier, there were very good reasons for encouraging the limitation of most shareholders' liability. Moreover, in terms of depositor protection banks' new ability to choose between these three options did make a difference, but not a huge one at the time. Usually, when subscribing to a share, a shareholder 'paid up' an initial portion of the price while the rest could be called in at directors' discretion, for example to expand the business, or in case of losses. Many limited liability banks, to maintain depositors' trust in the absence of deposit insurance, in fact asked for greater amounts of paid-up capital or uncalled capital to ensure a reasonable buffer.[22] Under 'reserve liability,' the only difference was that the uncalled portion could only be used in case of failure (so was kept in escrow, so to speak), and banks could ask for a defined multiple (double or triple) of this uncalled portion to be kept in reserve.[23] As a matter of fact, nearly all of these banks, whatever regime they chose, kept their depositors reasonably well protected and ensured a significant degree of skin in the game for executives, at least up to the 1890s (Turner 2014, pp. 126-9).

The problem with this legislation, however, was mainly threefold. First and foremost, as many pieces of legislation before and after it, its one-size-fits-all approach failed to differentiate between different types of shareholders with different levels of involvement in the bank. This is an issue regardless of the level of liability chosen: at extended levels of liability, executives' liability might be just right but that of the other shareholders might be too high; at low liability levels (for instance, pure limited liability), the liability of shareholders might be right but not that of executives.

Second, by refraining from imposing a set level of liability, and instead giving a choice between different levels, the law made it more likely that, with the rise of

[22] Formal deposit protection schemes only appeared in the 1970s in Britain.
[23] The idea was first clearly set out in the English context by Walter Bagehot in his article 'Limited Liability in Banking – 1' published in *The Economist* for May 17, 1862, vol. XX, pp. 536-8. It was developed in more detail by Rae (1885), and was inspired by colonial banking, especially in Australia and New Zealand.

central bank interventions and deposit insurance in the twentieth century, banks would choose the most limited (pure) form, thus leading to the case where executives' liability would be too low from the point of view of moral hazard and fairness. This is because, as the cost of failure was being gradually externalised to other banks and society as a whole, banks worried less and less about maintaining high reserves of capital, which became less essential to survival. While moral hazard and fairness would still call for greater liability among executives, if not to help the bank survive, at least to reduce costs to society, they became secondary concerns to banks who bore only a small portion of the cost of failure. As a result, the choice of pure limited liability became more likely, even as the need to hold executives to account remained from a societal perspective.

Third, even a significant level of liability (say double or triple) would not hold executives to account if the total amount due was meaningless relative to their remuneration and to the size of the bank's liabilities. In 1885, around 70 per cent of aggregate deposits were covered by shareholder capital, including any uncalled capital, reserve liability, paid-up capital and liquid reserves. By 1921 this ratio had fallen to 15 per cent. By 1950 it had fallen yet further (Turner 2014, p. 128). One of the primary reasons behind this decline was the rise in deposits due to war inflation, which was not matched by concurrent capital increases. Of course, deposit insurance does reduce the need for capital backing. But double or triple liability will not effectively reduce moral hazard and enhance fairness if this liability applies only to tiny amounts. This means that good legislation should require that executives hold a significant stake not only in absolute terms but also relative to their remuneration and to the bank's liabilities (and that their liability endures for a time after transfer; see Section 4 for more detail).[24]

While the latter two issues were not explicitly discussed, the one-size-fits-all problem was mentioned in places. There were in fact proposals for differentiating

[24] Interestingly, although the City of Glasgow Bank's *executive* directors had stakes above the median shareholding, some of the non-executive members of the 'Glasgow Board' held much greater amounts. For instance, Robert Craig had £20,467, while A. F. Sommerville had £11,000. Would the executive directors have been more careful had they held such large amounts?

between shareholder types, in particular requiring more extensive forms of liability for senior management specifically. However, these proposals were little discussed, and in one case, rejected offhand. In what follows we explain why and offer a preliminary critique of those reasons.

3.i *'Justice has been served'*

First, an arguably important feature of the popular psychology of the time was that, while the executive directors had certainly been the focus of attention during the trial itself, with detailed and lengthy commentary in the national and local presses, now that the trial was over and the sentence given, eyes turned to the fate of the mass of shareholders who were struggling to make good their commitments. Regarding the directors, popular feeling was that the possibility of moral hazard and injustice had been dealt with, that justice had been served; whereas something remained to be done for the other shareholders. Their plight took centre stage, and whatever happened to directors remained secondary. This is evident in Chancellor Stafford Northcote's speech on 21 April 1879, which announces the drafting of a Banking And Joint Stock Companies Bill.[25] In addition, as legislation needed to be passed quickly for political reasons, it was simpler to treat all individuals equally.

3.ii *'Reserve liability will tackle depositor protection, and audits will tackle moral hazard'*

Despite its defects, there was an understanding that reserve liability, as opposed to pure limited liability, would ensure effective depositor protection, as transpires from Mr Rathbone MP's defence of the bill (Hansard, HC debate 12 August 1879, col. 838).[26] But there was also an admission on the part of some economic

[25] He said that 'those who hear me are aware that, in consequence of some failures that took place in the course of last autumn, very great uneasiness and alarm has been created among shareholders in unlimited joint-stock banks; and, although I do not think that a panic or a great excitement is a reason for legislation upon a question of this kind, it cannot be denied that the alarm which has been excited and the considerations which have been brought forward in consequence of that alarm have opened our eyes to some defects and inconveniences in the law which at present affects joint-stock companies, and especially joint-stock banks' (Hansard, HC Debate 21 April 1879, col. 791).

[26] See also Wilson (1879), pp. 71-2.

commentators such as Alexander Wilson and several parliamentarians that the increasingly widespread adoption of more limited forms of liability, including reserve liability, might lead to excessive legal risk-taking on the part of executives (Wilson 1879, p. 129; Hansard, HC debate 12 August 1879, col. 838). However, in their view this could easily be solved by way of an amendment to the bill requiring the external professional audit of balance sheets each year. Alexander Wilson, for example, put great hope in it: 'the mere prospect of a periodical bank audit would practically do more to check abuses of this nature than any legal restrictions which could be devised' (Wilson 1879, p. 135; see also Evans and Quigley 1995; and Willison 2018).[27] This was not a new idea (Willison 2018), and the amendment was eventually adopted.[28]

Some MPs did express scepticism at the idea that audits would efficiently deal with more hazard. Already in his 1856 article entitled 'Sound Banking,' Walter Bagehot had warned that 'if the auditor knows anything of the business of the bank, it must be by being connected with the management, and then his audit ceases to be independent' (St John-Stevas 1978, vol. 9, p. 308). And as the bill was being discussed at committee stage in Parliament, Mr Bristowe MP likewise insisted that 'it was quite impossible that the auditors could dive into all the accounts of the money in the hands of the bank' (Hansard, HC Debate 12 August 1879, col. 859).[29] Such scepticism is still widely shared today (see, for instance, Kanagaretnam, Krishnan and Lobo 2010).

Among the most sceptical was William Mitchell, a Scottish solicitor to the Supreme Court, who wrote a 170-page pamphlet arguing for amendments to the banking bill (Mitchell 1879). Instead of relying on audits, he proposed to extend bank executives' liability in a way that would make it greater than general

[27] The 1862 Act had already recommended that banks do so.
[28] Another adopted amendment required that the balance sheet be signed not only by the auditor, but by the secretary or manager and three of the directors. This was 'to put an end to the practice of Directors not interesting themselves in the concerns of the bank they managed' (Hansard, HC Debate 12 August 1879, col. 869). Like the audit requirement, it reveals concerns about moral hazard embedded in the new law.
[29] The article 'Sound Banking' was published by Walter Bagehot in the *Saturday Review* for October 4, 1856, vol II, p. 494.

shareholders' liability. To the best of our knowledge, this was one of the first proposals for a graded form of liability, and it was phrased as follows:

> There does not seem to be any undue hardship to Directors in expecting them to undertake unlimited liability while that of the ordinary shareholders is limited. The Directors alone have the opportunity of satisfying themselves as to the soundness of the Bank, and by undertaking unlimited liability in connection with it they will evince their own confidence and at the same time increase that of shareholders and the public (Mitchell 1879, p. 130).

A similar suggestion was made by an anonymous commentator in 1859, arguing that 'surely it is most proper that the risk of all undertakings should be on those who have the means of knowing, and the power to regulate the amount of that risk' (n.a. 1859, p. 40).

The proposal for some form of 'two-tier' liability was also made in Parliament. Joseph McKenna MP drew a contrast between shareholders' access to information and directors', describing the latter as the 'only class of proprietors of a bank who could not be deceived.' This for him justified an amendment to the bill requiring that directors retain unlimited liability, up to one year after leaving office.[30] Yet the amendment was swiftly rejected by Chancellor Northcote himself, who immediately replied that 'the objection to the Amendment was that it would discourage men who would make desirable Directors from incurring the responsibility' (Hansard, HC Debate 12 August 1879, col. 863). It is to this argument that we now turn.

3.iii '*We will attract wealthier and more talented directors'*

There was a fear that imposing greater liability on senior management would attract men of low wealth, and inadequate talent and skill. This fear had its roots

[30] The full amendment was as follows: 'But no director of any existing company which shall register under this Act, shall have or be entitled to any limitation of his liability, by reason of such registration, until one year after he shall have ceased to be a director, and then only provided that no order for winding up or resolution for the dissolution of the company shall have been in the meantime made or formally determined upon' (Hansard, HC Debate 12 August 1879, col. 863).

in a much more general argument about all shareholders: keep liability unlimited, and bank shareholders will predominantly end up being 'men of straw' with neither the skill to understand bank balance sheets nor the wealth to make depositors good. This argument was assumed to apply to senior executives as well.

In a world without deposit insurance, the possibility that all shareholders might lack wealth could be a very significant issue. On the face of it, it seemed logical that an individual who had more to lose would be reluctant to take on unlimited liability, so that adverse selection would occur and only individuals of low wealth would end up owning the company. In case of insolvency, even an unlimited call might not bring much. This could have devastating consequences for the depositing public, reduce confidence in the banking system, with potentially self-fulfilling effects at times of panic.

This argument – that the mass of shareholders might be adversely selected – had been made before. One of the first proponents of the idea was William Clay, a parliamentarian, who as early as the 1830s had argued that unlimited liability attracted men of low wealth, intelligence and respectability (Willison 2018). The Bank of England had voiced similar concerns.[31] But its most vocal supporter was Walter Bagehot. He brought up the argument in several essays between 1856 and 1862. In his 1856 *Saturday Review* article, 'Unfettered Banking,' he expressed worry that only 'instead of allowing persons of real wealth to become shareholders in banks, we practically confine their foundation and management to comparatively needy and adventurous men' (St John-Stevas 1978, vol. 9, p. 311).[32]

The failure in 1857 of the Western Bank of Scotland, a large unlimited liability joint-stock bank, may have led to fears that wealthy shareholders of other unlimited concerns would quickly sell their stakes in realisation of the concrete

[31] One of its directors, Henry James Prescott, argued in 1854 that 'the dread of full liability deters the wealthiest and most influential classes from connecting themselves with banks' (Willison 2018).
[32] This article was printed in large type. It was published by Walter Bagehot in the *Saturday Review* for November 1, 1856, vol. II, pp. 583-5.

risks they were taking. This in turn would reduce the aggregate wealth available to shore up depositors in Britain. A piece of legislation in 1858 allowed banks to register as limited liability companies just like other joint-stock ones. Some banks, such as Overend and Gurney, did re-incorporate as limited liability concerns.[33] And yet, most in the banking community were against the spread of limited liability as they worried the limited form would play a bigger role in reducing the amount of capital backing the banking system and scare depositors away (Turner 2009).[34]

After the City of Glasgow Bank failure however, the argument gained further traction. Chancellor Northcote feared that:

> gentlemen of large means, who are just those whom the public would desire to see occupying positions as shareholders in great institutions, will be unwilling to put themselves in that position, and will withdraw; and so this unlimited liability will lead to the substitution as shareholders of a very inferior class of persons whose liability, although unlimited in name, will not be worth nearly so much to the public and the creditors of the concern as might be the limited liability of a superior class of persons (Hansard, HC debate 21 April 1879, col. 792).

The argument was also expounded at length by Alexander Wilson.[35] It also occurs in the *Bankers' Magazine*.[36]

The argument applied to bank directors as well. Wilson worried that retaining unlimited liability for directors would 'undoubtedly produce deterioration in the quality of directorates' (Wilson, 1879, p. 129). Mr Heygate MP believed that:

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[33] Whether this played a role or not in its eventual failure in 1866 remains to be determined.
[34] Limited liability could reduce capital backing by putting a ceiling on the total amount that could be called in the event of losses, as well as by limiting senior executives' stake in the bank's survival and therefore their incentive to maintain high levels of capital. See comments below on the Royal Mercantile Commission for more detail on bankers' opinions.
[35] He worried about 'the prospect of a deterioration in the quality of the names on their shareholders' registers' (Wilson 1879, p. 70).
[36] The *Bankers' Magazine* expressed concern about 'the substitution as shareholders of men of straw for men of substance.' See volume 14(4), Oct 1879, p. 261.

> everyone connected with banking business knew there was no greater difficulty than that of finding a good set of men to undertake the management of a joint-stock bank; and if the principle of the Bill was adopted, so as to become general, he thought it would tend to the advantage of the public in securing both a better class of shareholders and a better class of directors (Hansard, HC debate 21 April 1879, col. 804).

As we saw, it was the chief reason advanced by the Chancellor of the Exchequer when Joseph McKenna proposed his amendment.[37]

Yet the argument lacks evidence. Bank managers kept a close eye on shareholders' identity, and thus their wealth. They had, in most cases, the right to vet share sales, which gave them significant power to deny entry to a prospective shareholder of insufficient means. In addition, since 1862 a clause in the law ensured that unlimited liability would be kept for a year in case of share transfer, which created a disincentive to sell even as a banks' prospects diminished. Carr and Matthewson (1988), Acheson and Turner (2008) and Hickson and Turner (2003) have convincingly shown that thanks to this vetting process, most bank shareholders were quite wealthy (see also Lee 2012). At the time of their appointment, most of the directors of the City of Glasgow Bank were also likely wealthy men meeting contemporary criteria for 'respectability' (with one exception).[38] Their incentives to check each other's credentials were strong under unlimited liability. It remains true however that as the years went by following

[37] Walter Bagehot had additional adverse selection worries regarding directors. For example, he thought making it illegal for directors to borrow from their bank would repel prospective directors who were also merchants ('in trade'), which would mean that 'the foundation and direction of banks would fall into the hands of inferior persons' (St John-Stevas 1978, vol. 9, p. 215).

[38] Many of the directors, were well-known merchants – for instance Lewis Potter, and William Taylor, director of the firm Henry Taylor and Sons, grain merchants. The latter was also a Member of the Glasgow School Board and the Town Council. There were others who held official appointments, such as Henry Inglis, who was Substitute Grand Master of Scotland and Deputy Lieutenant of Morayshire (n.a. 1879, pp. 3-4). The exception was John Innes Wright, who was actually induced by the other directors to borrow from the bank to buy his stock requirement in order to become director. The reason he was pressed to take up the directorship after James Nicol Fleming resigned was probably that he was one of the only persons already in the know about the bank's troubles and (reluctantly) willing to take up the position as his own firm was connected to James Nicol Fleming's (Wallace 1905, pp. 205, 370-408).

their appointment, these incentives were weakened by other factors. This calls for specific safeguards to be put in place (see Section 4 below).

Importantly, this evidence suggests that the pool of prospective shareholders was usually large. An unlimited bank inspired trust, which in turn brought in more investors and depositors.[39] This might raise the probability of profitable business opportunities. Unsurprisingly, the potential for growth and stability was an attractive prospect to shareholders and directors alike. The responses to the questionnaires sent by the Royal Mercantile Laws Commission in 1854 show that although lawyers, academics and MPs were in favour of limiting liability for banks, those leaning against a change in the law were more likely to be bank executives themselves (Willison 2018; see also Bryer 1997).[40] Walter Bagehot himself only believed that adverse selection might become more common *in future*, and admitted that this belief was not based on observed facts. On contrary, as he openly conceded in 1862:

> Experience shows that under a system of unlimited liability a good board of directors may… be readily obtained. The success of the great London joint stock banks, which were all founded when limited liability was not permitted by law, is on this point conclusive… they could not have been steadily and regularly successful, with scarcely a check or drawback during so many years, if their management had not been admirable or excellent (St John-Stevas 1978, vol. 9., p. 395).[41]

It seems that there was no shortage of talent and skill in London at the time, despite most other industrial and trade concerns being incorporated under limited liability (see also Goodhart and Lastra 2020; and Bair et al. 2023).

Over the past eighty years or so, the rise of deposit insurance has reduced stability worries somewhat, which has meant that, while fairness had always been a secondary concern for banks, reducing moral hazard also increasingly became a

[39] When Joseph McKenna MP proposed to retain unlimited liability for bank directors, one of his chief arguments was that it would 'give the public three or four times as much confidence in its dealings with banks' (Hansard, HC Debate 12 August 1879, col. 863).
[40] The Commission ended up recommending against a change in the law (Willison 2018).
[41] This was published by Walter Bagehot in *The Economist* for May 17, 1862, vol. XX, pp. 536-8.

secondary objective, as it would make a smaller difference in terms of nurturing trust in the bank, and thus increasing business opportunities. This could potentially reduce the pool of prospective managers attracted to a job with extended liability attached to it.

At the same time, over the past few years the notion of corporate social responsibility has gained momentum and has started to affect the cost of capital (El Ghoul et al. 2011). Deposit insurance and central bank interventions have simply shifted costs to wider society. A bank who benefits economically from sending strong signals about concerns for these greater social costs will be more likely to give renewed importance to moral hazard and fairness. This, in turn, should make an extended liability job more attractive than would have been the case two or three decades ago.

Yet it is still possible that, especially in today's hyper-competitive corporate world, extended senior management liability in some sectors or countries might deter prospective candidates relative to other sectors and nations. But solutions can be found to keep the job attractive without jeopardizing the initial objectives. In the section that follows, after having reviewed historical examples of graded liability, we discuss possible practical solutions to this issue. While we refrain from arguing for a specific model, our aim is to suggest that there is, indeed, a range of available options to bring this reform forward successfully.

4. Graded liability: past, present and future

The idea of applying different levels of liability to different members of an enterprise is far from new. Some of the earliest forms of graded forms of liability can be found in late medieval Europe. Although rare, they remain present in many continental European countries. In some of these instances, the issue of the job's attractiveness for senior executives was clearly an important one. It has been dealt with in various ways, which in our view were not always sustainable. Whatever precise version of this model ends up being implemented, it would seem that three

aspects of graded liability remain key. First, that the highest tiers of liability, though extensive, remain limited to a certain amount (except perhaps in the case of the Chief Executive Officer or CEO). Second, that those with extended liability be compensated financially, but not otherwise. Third, that a Court of Appeal be instituted to deal with extreme cases where banks have to undergo resolution for entirely external reasons (for instance an earthquake). Finally, safeguards need to be put in place, specifically to do with the requirement to own shares and the longevity of liability, which we discuss at the end.

As early as the twelfth century, some of the earliest legal corporate forms had graded liability. For instance, whenever a mill was established in southwestern France, a contract was drawn between the miller, with responsibility both for management and losses, and the individuals who brought in capital, gained from the enterprise but would not be responsible for shortfalls (Cartier and Charlier 2012). Later, the well-known economic success of medieval Venice had some of its roots in the efficient legal organisation of maritime commerce, which was partly based on graded liability. There, unlimited liability partnerships, *compagnia*, coexisted with *commenda*, which were essentially limited liability joint-stock companies in which managers held both more power and unlimited liability – in other words, graded liability companies (Carmona 1964). Almost every trading ship was a *commenda*, in which limited liability investors were keen to invest while the ship's captain remained solely responsible for the enterprise's (and his own) survival while at sea. In Tuscany, partnerships were very common until the *commenda* arrived from Venice and gradually became preponderant in such city-states as Florence (after 1408), Lucca (after 1554) and Livorno, encompassing all kinds of trades, including banking.

In the *commenda*, the managing partners had knowledge and control (*governo*) over the affairs of the company. They also ran greater risks than the shareholders and were commonly allowed special remuneration as a result. Compensation practices differed across companies. Executives could, for instance, have an especially large amount of capital invested, so that any gains would be very

significant. Or they could, given a specific level of capital, gain more relative to this capital than would be the case in a limited company. The latter case seems to have been more common (Carmona 1964).

More recently, there is evidence that France has also sought to compensate managing partners for their increased liability relative to the other shareholders. France still has around 300 *sociétés en commandite*, and this number has remained stable since 2000, including a few among the largest French businesses (Cartier and Charlier 2012).[42] In *sociétés en commandite*, as in medieval Venice and Renaissance Tuscany, executives have unlimited liability while the mass of shareholders are only liable in a limited way. To compensate the former for their extra liability, *sociétés en commandite* give them not extra remuneration, but extra power. Executives usually cannot be ousted by shareholders except in extreme circumstances, and even then, it might be difficult.[43] This quasi-autocratic framework may continue to attract candidates to the job, but is facing an increasing backlash among shareholders, as the recent abandonment of the corporate form by Lagardère Group, an entertainment and travel retail giant, has shown.[44] If it is not already the case, it is likely that this form will soon seem archaic.

In the end, it appears that it would be best to go back and think of compensation in a similar way as Renaissance merchants from Lucca envisioned it, that is, to think of optimal ways to attract candidates to senior management roles without resorting to extreme empowerment.

A basic way of ensuring a consistent, highly-skilled labour supply at executive level might first be to define liability clearly. Indeed, even Walter Bagehot,

[42] These include such big names as Michelin, Hermès and EuroDisney.
[43] A 'Monitoring Council' (*Conseil de Surveillance*) made up of shareholder representatives can sometimes recommend the termination of executives' contracts, but this cannot be done without the executives' assent. And executives can decide to terminate other executives' contracts even if the Monitoring Council disagrees.
[44] An additional problem has been a legal loophole allowing a limited liability company to act as executive within a *société en commandite*, which of course defeats the purpose of unlimited liability. It has been widely criticised.

sometimes portrayed as supporting pure limited liability, in fact insisted simply on executive directors' liability being *defined* rather than unlimited, even if that meant up to five times the original amount invested. In his mind it was important that senior managers should take risks in the enterprise: 'It is necessary that directors should have a large risk in the undertaking' (St John-Stevas 1978, vol. 9, p. 397).[45] But there would be no shortage of good directors, provided their liability was well defined: 'they would be ready, perhaps, to go to five times that amount. They are anxious there should be a limit, but they would not care comparatively where the limit was placed' (ibid., p. 310).[46]

Within this framework, one could envisage various systems of graded liability, which would be applied as soon as losses occur. In one of them, liability would be pre-defined at a specific, single multiple of accumulated revenue for all 'Insiders' (for instance, double), whereas the 'Outsider' shareholders would retain pure limited liability. Deciding what constitutes an 'Insider' would have its challenges, but the advantage of such a two-tier system would be that, once defined, it would be relatively simple and intelligible to all. Goodhart and Lastra (2020) suggest that 'Insiders' include all of the Board of Directors, including the externals, as well as any employee earning a salary in excess of 50% of that of the CEO.[47] As some employees might avoid liability by adjusting their salary, the regulatory authority should also be able to designate 'Insiders,' including retrospectively.[48]

Another system might be one which also distinguishes between 'Insiders' and 'Outsiders,' but where liability would be graded among the 'Insiders' themselves. As CEOs have much more information and power than anyone else, they could have triple liability, while Board members and chief officers would have double

[45] This is an excerpt of the article 'Limited Liability in Banking – 1' published by Walter Bagehot in *The Economist* for May 17, 1862, vol. XX, pp. 536-8.
[46] This is an excerpt of the article 'Sound Banking' was published by Walter Bagehot in the *Saturday Review* for October 4, 1856, vol II, p. 494.
[47] Non-executive directors often receive very little remuneration, and the power and knowledge are limited, so they would not have extended liability in this system.
[48] The Prudential Regulation Authority and the Financial Conduct Authority already require that responsibilities be clearly defined under the Senior Management and Certification Regime, which should greatly help in this direction. See Goodhart and Lastra (2020) for more detail on how this system would work.

liability and anyone else within the 'Insider' category would have less. Large shareholders might also be included in the 'Insider' category and might face graded liability according to the amount of their holdings.

Next, extra remuneration during good times for those bearing greater liability in bad may be considered. The logic behind this would be twofold. First, it might maintain job attractiveness in a world where other sectors would retain pure limited liability. Second, greater liability comes with greater involvement, and greater involvement could be rewarded in good times. Walter Bagehot was clear that remuneration should be significant, if only because otherwise the threat of multiple liability would be meaningless.[49] Greater remuneration in good times would not defeat the purpose of greater liability, as liability itself would always be calculated as a function of accumulated revenue in good times (see below).[50] It was also supported by Mitchell when arguing for graded liability (Mitchell 1879, p. 131).[51]

Third, allowance should be made for cases where extended senior management liability would seem unfair in light of general circumstances. For instance, if an 'Insider' gains awareness of management practices that need changing, but does not succeed in convincing others, they could send a letter to the regulator making their views known (these would then need to be examined and evaluated by the latter).[52] One might also consider the constitution of a Court of Appeal to deal with cases where banks make losses due to highly unusual but significant events originating outside the banking system, such as natural disasters.

Some might add that an initial failure of a bank may lead quickly to a systemic crisis in which there is a generalised withdrawal of deposits from banks, both good

[49] 'The banker… should be so thoroughly remunerated that his clear interest is rather to retain his position by employing our money well than to risk it by employing it ill' (St John-Stevas 1978, vol. 9, p. 306). This article was printed in large type in the *Saturday Review* for November 1, 1856, vol. II, pp. 583-5.
[50] This was also proposed by Goodhart and Lastra (2020).
[51] He said: 'But such an undertaking on their part would naturally evoke from the shareholders a proposal to remunerate the services of the Directorate on a more liberal scale than hitherto.'
[52] More detail in Goodhart and Lastra (2020).

and bad. But, in practice, the normal progression of such a crisis involves depositors and other creditors first looking around for the next weakest bank (to the initial failing bank). Recent examples include Signature Bank after Silicon Valley Bank in 2023 and Bradford and Bingley after Northern Rock in 2007-8. By the time that concerns turn into a more generalised panic, the Central Bank is virtually bound to step in, in order to protect the financial system as a whole. For these other banks liability rules then become less relevant.

Finally, some safeguards need to be designed and put in place to ensure that the incentives to reduce moral hazard are not jeopardized by ways of escaping liability or becoming immune to its effects. As mentioned earlier, some of the City of Glasgow Bank executive directors had initially held large stakes and gradually reduced them to the bare minimum required by the time the failure occurred. This reinforces the importance of calculating liability as a function of accumulated bank liabilities and senior executive revenue in good times. Some of the directors were also heavily indebted to the bank, and one of them even borrowed from the bank to buy his stake. This calls for restrictions on borrowing. Finally, some of the directors' firms had connections to some of the firms the bank was lending to. These conflicts of interest change the balance of incentives and should be strictly regulated. It is also likely that a such a framework would need to be applied to nonbanks.

While much work remains to be done in the precise calibration of an optimal graded liability system, the point of this section is to show that the idea is not new, and that although practical issues do arise, solutions can be found.

5. Conclusion

The failure of the City of Glasgow Bank in 1878 revealed how unfair it was for 'outside' shareholders, with little, or no, access to information or power over the decisions of their bank to suffer unlimited liability. That such shareholders should have limited liability was then, and remains, generally accepted. But that then

raises the question of what should be the liability of 'insider' shareholders, a question that was, indeed, considered at the time. The main argument that was levied against some form of multiple, or graded, liability was that it 'would discourage men who would make desirable Directors from incurring the responsibility'.

In this paper we argue that such concerns were not properly based on evidence and were much overstated. There remains a strong case for some form of additional graded liability for 'insiders' on grounds both of social justice and for the limitation of moral hazard. Moreover, the lack of any such grading has led to a developing thicket of regulatory and supervisory controls over banks as may make financial intermediation less efficient.

While we argue for a positive reconsideration of graded liability for bank executives, there are many outstanding questions, such as the definition of (various rungs of) insiders, the scale of such extra liability, and whether there should be the ability to` appeal against penalty when failure was due to unpreventable external forces. So, the adoption of graded liability would be a complex matter. Nevertheless, we think that it could, and should, be attempted.

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