Journal of Financial Regulation, 2020, 6, 1–40
doi: 10.1093/jfr/fjz010
Advance Access Publication Date: 11 March 2020
Article

OXFORD

Equity Finance: Matching Liability to Power

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ABSTRACT

In this article we question the wisdom of limited liability for all equity holders in the case of banks and systemically important financial institutions (SIFIs), though our proposals could be extended to all public limited companies. Limited liability can be a major source of moral hazard and excessive risk taking—a privilege that allows shareholders to enjoy the upside from their commercial activity while limiting their exposure in the event of failure. We propose that there should be two different classes of equity for banks and SIFIs. The division should be between outsiders, with no inside knowledge of the working of the firm and/or ability to control its decisions, and insiders, who have both the information and capacity to influence corporate decision-making. Outsiders would remain with limited liability, while multiple liability (double, triple, and potentially unlimited) would apply to insiders. The purpose of our proposal is to shift the costs of failure back to those who have responsibility for taking these decisions. The idea of financial liability 'with teeth'—which is rooted in history—provides an innovative solution that improves the incentives for managers to take responsible decisions, and promotes a radical change in the structure of capitalism—addressing the unfairness of the current system which has enhanced inequality and encouraged populism.

KEYWORDS: equity; limited and multiple liability; managerial remuneration; insiders; banking; SIFIs

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We would like to acknowledge with gratitude the excellent and extensive research assistance provided by Alan Brener together with helpful contributions by Peter Andrews, Dean Buckner, Sandra Boss, Charles Calomiris, Peter Conti-Brown, Kevin Dowd, Benjamin Friedman, Andromachi Georgosouli, Simon Gleeson, Alexander Hoare, Tom Huertas, Calvin Jackson, Dirk Jenter, Edward Kane, Joseph Gitau Mburu, Eva Micheler, Andrea Miglionico, Katrien Morbée, Guy Morton, Spyros Pagratis, Marke Raines, Philip Rawlings, Rafael Repullo, Susan Rice, Marcelo Sheppard, Steven Schwarcz, Peter Sinclair, Luc Thévenoz, Simon Watkins, Matthew Willison, Tim Young, Amy and Bert Westbrook, as well as the anonymous reviewers for the Journal of Financial Regulation. We are also grateful for the comments received when we presented this paper at the Bank of England on 1 May 2019, at the London Financial Regulation Seminar on 13 May 2019, and at a joint event hosted by the Financial Conduct Authority (FCA), the Systemic Risk Centre (SRC) and the Financial Markets Group of the LSE on 21 May 2019. An earlier draft was published as CEPR Discussion Paper 13494, available at <https://cepr.org/active/publications/discussion_papers/dp.php?dpno=13494>.

I. INTRODUCTION

In the Lex commentary in the *Financial Times* on 25 September 2019 (at 12), it was noted that:

> The collapse of Thomas Cook shows reform is needed. The UK needs a tax on disappointments. This is the only answer to public anger over the demise of a 178-year-old business that has left holidaymakers stranded. Chief executives who received pay typical to their station turned out to be a bit useless. They should be made to suffer.

This article provides a blueprint to achieve this result.

Similarly, in his regular Monday morning column in *The Daily Telegraph* (4 June 2018), the economist, Roger Bootle wrote,

> Market failure applies most notably with regard to executive pay. In practice, senior pay awards are decided by a cosy cabal, reminiscent of the worst of trade union excesses.[1] It isn't usually the level of pay that infuriates people. It is rather the often sketchy relationship between pay and performance and, especially, the lack of appropriate downsides in the event of individual or corporate failure. This is the very opposite of capitalism in the raw, which depends as much upon the purging effect of failure as the incentivising effect of success.

The basic problem is that chief executive officers (CEOs), and other senior managers, are significantly remunerated in ways that depend on the level of equity prices (also known as the bonus culture) and equity holders have limited liability. With unlimited upside potential, but limited downside, this puts an equity holder into the position of having a call option[2] on the residual assets of the enterprise. The value of such options increases with risk. This is because when the downside risk occurs, those with limited liability can shift the risk onto the other creditors, depositors, bond holders, trade creditors, and taxpayers. Meanwhile managers who drive their companies into bankruptcy, or near it, continue to receive large compensation packages despite this.

In simple terms, equity holders with limited liability are insured against the risk of really bad outcomes. When such (tail) risk occurs, such equity holders can shift the costs onto others—such as employees, creditors of various kinds, and, in the last resort, taxpayers—and managers continue to get paid, often handsomely, even if the company does badly.

The limited liability of equity holders is, we contend, by far the biggest source of moral hazard and risk shifting in a capitalist economy. Yet the 'moral hazard fundamentalists', to use[3], have tended to focus on less central features of our system, such as deposit insurance, mutual fiscal support, and other forms of insurance against adversity. Has there been some (unconscious?) bias in the identification of 'moral hazard'?

A consequence of limited liability for shareholders is that the return on their investment, as a function of the net worth of the firm in which they have an equity share, is flat

1 Also see inter alia Deborah Hargreaves, *Are Chief Executives Overpaid?* (Polity Press 2018).

2 As originally noted in Stephen A., Andrew A., Edward J., 'Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital'(1981) 36(1) Journal of Finance 51.

3 Timothy F. Geithner, Stress Test: Reflections on Financial Crises (New York: Crown 2014) 9.

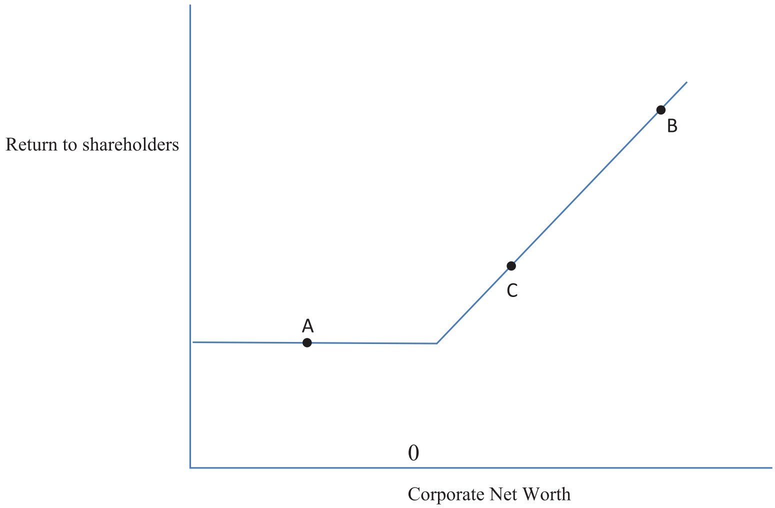

Figure 1. Shareholder preference for risk

when the company is doing really badly[4] or becomes insolvent, but is strongly upwards sloping when the public company is doing well. This is shown graphically in Figure 1.

With a return structure of this kind, the shareholders are led to prefer a riskier strategy, as shown in Figure 1, with an even chance of an outcome of A and B, rather than a completely safe policy, as shown in the diagram at point C. So, shareholders have an innate preference to encourage management to take on riskier activities. Such shareholder preference for risk is somewhat abated by loss aversion, as discussed by, for example, Kahneman.[5] But that, in turn, is reduced by appropriate diversification, so that the loss involved on any single portfolio holding is limited.[6] So, the implication is that limited liability naturally leads shareholders to push management to adopt riskier strategies than would be socially optimal.

4 In practice, managers usually do considerably better than shareholders when companies do badly, eg make losses, but not badly enough to become non-viable or insolvent. This is because their overall remuneration packages are generally much better protected against such losses than shareholder dividends and equity valuations. Our proposals, set out in section III below, also aim to rectify this differentiation. Also see Oxera, April 2019, *Agenda*, 'The puzzle of regulatory pay: practical solutions for fines and supervisors' at 2:

> Inline with the hypothesis that managers need to be incentivised in order to make an effort, many firms designed employment contracts to award managers with higher pay for generating additional profits. But contracts were less successful at incentivising managers to generate profits without taking large risks. From a manager's perspective, this resulted in decisions to take risks with highly asymmetric consequences: heads, they won; tails, their employer lost.

5 D Kahneman, *Thinking, Fast and Slow* (Penguin Books 2012). Part IV on Choices, at 269–376, focuses on loss aversion.

6 John Armour and Jeffrey Gordon argue that—with respect to systemic risk at least—diversified shareholders do care, as the systemic spillovers—to a limited extent—will produce losses throughout their diversified portfolio. Armour and Gordon propose officer and director liability rules as a complement to (and substitute for) the prescriptive financial regulation that has emerged from the financial crisis. John Armour and Jeffrey Gordon, 'Systemic Harms and Shareholder Value' (2014) 6(1) Journal of Legal Analysis at 54–55 https://academic.oup.com/jla/article/6/1/35/933345>.

In earlier years the pressure on management was mitigated by the fact that managers were primarily paid by a cash salary unrelated to equity valuation. Moreover, other considerations, such as reputation and pride in developing a successful company over the long term, had the effect of constraining managers' willingness to take on risk. But, one of the other possible incentives for managers, as a result, was to spend resources on activities that might bolster managerial reputation and personal comfort, rather than maximizing profits. Such considerations involved business size and spending money on managerial perks, including not only such perks as company planes and chauffeur driven cars, but also fancy, prestigious architecture, head offices, etc. As a result, the cry went up that managerial incentives should become better aligned with the interests of shareholders.

Partly in response to public attitudes then, about soaring managerial pay and perks, President Clinton introduced measures in 1993,

> when he effectively set a $1 million limit on directors' pay by making anything above that level non-tax deductible for companies. However, in the small print of his legislation, was a clause that specified payments with performance conditions were exempt from the $1 million rule. That effectively meant company boards boosted all salaries to $1 million and paid bonuses and extras in stock options that directors could cash in for shares at a later date. This prompted an explosion in executive awards . . .[7]

The result of such alignment of managerial incentives with those of shareholders, in some large part consciously done, resulted in there being the exact same incentive on management to give priority to policies that would maximize equity valuation; naturally this would generally lead them to pursue additional risk.[8] Moreover, the expected lifetime incumbency of most CEOs is relatively short—five years or less—and that means that the incentive for them is to maximize short-term equity valuations.[9] This can most easily be achieved by accepting a riskier financial structure, for example buybacks to increase leverage and raise the return on equity (RoE),[10] reducing the

7 Hargreaves, (note 1) 77.

8 It also led them to manipulate reported earnings, with the connivance of their auditors, so as to show a steady upwards path, and both to shape and then to exceed the predictions of security analysts. On this, see Frank Dobbin and Dirk Zorn, 'Corporate Malfeasance and the Myth of Shareholder Value' (2005) 17 Political Power and Social Theory 179, and also D Zorn, F Dobbin, J Dierkes and MS Kwok, 'Managing Investors: How Financial Markets Reshaped the American Firm' in KK Cetina and A Preda (eds), *The Sociology of Financial Markets* (OUP 2004).

9 Bebchuk, Alma Cohen and Holger Spamann show that managers were able to cash in a lot of the profits before the collapse in 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008' (2010) 27(2) Yale Journal on Regulation. Lucian and Holger deal with moral hazard inherent in bankers' pay in 'Regulating Bankers' Pay', *Harvard Law School John M Olin Center for Law, Economics and Business Discussion Paper Series* Paper 634 (2009) 98 Georgetown Law Journal 247. Michael Jensen and William Meckling deal with the distinction between pecuniary and non-pecuniary benefits in 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305.

10 See eg Spyros Pagratis, Eleni and Helen, 'Are banks using leverage to target return on equity: Evidence from the US and the EU', *Oxford Economic Papers* (2019).

headcount of employment, and cutting out longer-term investment, notably in R&D, whose return is unlikely to become clear for a long time.[11]

The South Sea Bubble exposed the perils of equity financing and the moral hazard inherent in limited liability equity usage (which has currently slipped under the radar[12]) was prominent in the minds of all concerned in the Victorian era—investors, entrepreneurs, and the authorities. Since our examination of this involves a lengthy, stand-alone, historical study, we have put this record of the use of unlimited liability, and then double liability in the case of national banks in the US, with reference also to a few instances of applying particular liability requirements to specific classes of equity holders, in a separate Appendix.

Box 1

Commercial enterprises had been legally structured as partnerships with unlimited liability until the nineteenth century. Limited liability was a legal innovation of the nineteenth century. It became one of the constituent elements of the joint stock company (Société Anonyme, S.A. in France or Spain, Aktiengesellschaft or A.G. in Germany), though the advent of this corporate form preceded the advent of limited liability (the name 'company' is typically used in the UK, while the US uses the term 'corporation').

The principles of partnership and unlimited liability had been considered as 'natural and beneficent' in the early nineteenth century,[13] since they promoted responsibility and accountability.

Under limited liability, a shareholder can participate in the growth of the company but that shareholder's liability is restricted to the amount invested in the company. If the company as an entity endowed with legal personality[14] goes bankrupt, the shareholders' liability remains limited to the value of their invest-

11 There is a counter-argument pointing to the high stock market valuations of tech companies which during their early lives can be expected to pay out nothing; with the implication that this shows that shareholders and management do give proper full valuation to longer-term future returns. But the prospects for such companies are inherently risky, and it is the lure of potentially massive future returns, with an offsetting significant probability of total collapse, that attracts investors, rather than the long-term nature of their activities per se.

12 Though see Steven Schwarcz, 'The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability' (2014) 90 Notre Dame Law Review 1 <http://ssrn.com/abstract=2364126>. See also Paddy Ireland, '*Limited liability, shareholder rights and the problem of corporate irresponsibility' (2008) 34(5) Cambridge Journal of Economics 837 and* Richard Button, Samuel Knott, Conor Macmanus and Matthew Willison, 'Desperate adventurers and men of straw: the failure of City of Glasgow Bank and its enduring impact on the UK banking system' (2015) Bank of England Quarterly Bulletin 27.

13 *See Ireland (n 11).*

14 The relationship between limited liability and the fiction of a company's legal personality requires further research which is beyond the scope of this article.

ments, and shareholders have no personal liability for the company's debts. Thus the company is liable for the rest of the debt obligations.[15]

While it is widely accepted that joint stock companies with limited liability and separate legal personality contributed to the expansion of the capitalist system, there have been misgivings from the beginning about the benefits of this legal form for banks (and insurance companies). Those misgivings have returned to haunt us in the aftermath of the global financial crisis.

As stated by Charles Dumas in his recent book *Populism and Economics*, 'an awkward question exposed by the ebbing of the financial crisis is whether the *limited liability company,* a cornerstone of the world's economic system for more than a century, played a part in causing and prolonging that crisis and therefore now needs reform'.[16] Limited liability is after all 'a major privilege' that allows shareholders as well as senior directors or managers to enjoy the upside from their commercial activity while limiting their exposure to losses in the event of failure or bankruptcy ('skewed incentives').[17]

History provides a range of different liability regimes—from unlimited liability, to double or multiple liability, and then to single limited liability. We will examine this in a lengthy, stand-alone, historical study, which can be found in the Appendix to this article. The Appendix is divided into four parts. First, we examine the record of double liability for banks in the US. Secondly, we focus on the UK experience with special mention to the collapse of City of Glasgow Bank. The last two subsections very briefly consider the history of double liability in Canada and some examples of limiting liability in a few European jurisdictions.

Historical evidence, we suggest, supports our proposal for a different liability regime for banks, which we refer to as 'intermediate' or 'partial' liability (a category between limited and unlimited liability) and which is an alternative to the current regime of shareholder limited liability.

15 See Amy and David A Westbrook, 'Unicorns, Guardians, and the Concentration of the U.S. Equity Markets' (2018) 96 *Nebraska Law Review 688* and <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3200415>. The idea that shareholders ought to bear more responsibility ties into the fundamental anxiety of creating legal persons, that the fiction will not hold up under pressure. That the banks will dissolve, be floated, whatever, and real people will be hurt, but no real people will be responsible. So much of the nineteenth century law, eg, par value, shareholder appraisal rights, etc, can be seen as making sure the firm is really 'there' for the shareholders and for third parties. See generally Morton J. Horwitz, Transformation of American Law, 1870–1960, (New York: Oxford University Press 1992) 73. Much of the twentieth century can be seen as the whittling away of such devices for making corporations more solid, in the name of entrepreneurship, risk taking, innovation, and the like. The classic relatively recent statement was the last decision in the tortuous Disney litigation, in which truly bad board decisions were ultimately defended under the business judgement rule, in order to ensure that capital would be put at risk, people would agree to direct such capital, etc. Amy Westbrook has gone so far as to argue that, absent serious self-dealing, the board's legal responsibility has, as a practical matter, all but disappeared. It simply is not litigable in Delaware. See 'Does Banking Law Have Something to Teach Corporate Law about Director Duties' <http://washburnlaw.edu/profiles/faculty/activity/westbrook-amy.html.>

16 See Charles Dumas, *Populism and Economics* (Profile Books 2018) 166.

17 Ibid 166–7.

The basic reason why unlimited, or multiple, liability requirements for equity holders became progressively abandoned during the latter part of the nineteenth and first half of the twentieth century was that these required that such equity holders had wealth (to meet such potential liability), knowledge about other equity holders and the enterprise, and sufficient power to prevent the enterprise becoming unduly risky. In other words, in an unlimited liability world, equity holders had to be predominantly 'insiders'; equities at that time were just too risky for 'outsiders' to hold.

Towards the end of the nineteenth century the scale of the efficient enterprise, such as steel production, chemicals, railways, banks, etc, became sufficiently large that the required equity base (if the enterprise was not to become too excessively leveraged) became too large for insiders, for example family and friends, to finance on their own. Equity finance now had to be provided by the much larger mass of outsiders, who had neither power to control the working of the enterprise nor access to detailed information, and often did not have the wealth to face unlimited, or even multiple, liability. As set out in more detail in section II, there was a tendency in the US during the 1920s to encourage a wider range of (outsider) shareholding. When the Depression hit in the early 1930s, attempts to call on the additional liability of such outside shareholders proved to have high transaction costs, together with generating considerable political opposition. The result was a general acceptance of limited liability for all, which has continued until today.

As *The Economist* wrote[18] in 1926:

> The economic historian of the future may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honor with Watt and Stephenson, and other pioneers of the Industrial Revolution. The genius of these men produced the means by which man's command of natural resources was multiplied many times over; the limited liability company, the means by which huge aggregations of capital required to give effect to their discoveries were collected, organized, and efficiently administered.[19]

II. SOME PRIOR PROPOSALS TO REFORM CAPITALISM

The criticism of limited liability companies, despite the encomiums of *The Economist*, has several facets; it is argued that it leads to managers assuming excessive risk, being overpaid, and failing to undertake sufficient long-term investment, especially R&D.[20] The first two criticisms—excessive risk and excessive pay—were particularly levied

18 Also see Bainbridge and Todd Henderson, *Limited Liability: A Legal and Economic Analysis* (Edward Elgar 2016).

19 *The Economist* (18 December 1926).

20 In a recent article entitled 'Rethink the purpose of the corporation' (*Financial Times*, 12 December 2018), Martin Wolf criticizes the mantra of shareholder value maximization, affirming that in the cases of highly leveraged banking the Anglo American model of corporate governance does not work. He refers to a number of books—including Colin Mayer's 2018 *Prosperity*—that suggest that capitalism is substantially broken. In a similar vein, John Plender in 'Shareholders dethroned as rulers of value' (*Financial Times*, 3 January 2019), criticizes the existing corporate governance model of shareholder primacy and advocates the redefinition of directors' legal duties to other stakeholders, following investors' greater emphasis on environmental and social factors in corporate performance, while Andrew Edgecliffe-Johnson in 'Beyond the bottom line' (*Financial Times*, 5/6 January 2019) also questions the doctrine of shareholder primacy

at banks and other financial intermediaries in the aftermath of the great financial of 2008. There have been a variety of proposals aimed at checking or preventing such malfunctions. One set of such proposals has focused on revising and limiting the business structures of banks and other financial intermediaries. Examples of such proposals include narrow banking in various guises, ringfencing of core retail financial structures, and a variety of other regulatory measures. A recent addition to this set is by Conti-Brown, arguing for the abolition of limited liability for Systemically Important Financial Institutions (SIFIs), unless they become very highly capitalized.

Box 2

Conti-Brown[21] seeks to solve the problem of bailouts by means of a legal mechanism he calls 'elective shareholder liability' which he claims is less intrusive and more effective than the regulatory solutions of Dodd-Frank.

Elective shareholder liability gives shareholders of SIFIs the choice between reducing the firm's leverage by increasing capital significantly or by creating a bailout exception to the SIFI's limited liability status, such that the government can recoup the losses associated with any taxpayer bailout from the SIFI shareholders directly. By having shareholders instead of taxpayers cover the ultimate costs of the bank's failure, the incentive structure is radically altered.

Elective shareholder liability could be structured as a governmental collection, similar to a tax assessment, for the recoupment of all bailout costs against the shareholders on a pro rata basis. The proposed structure would also give the government the authority to declare the shareholders' use of the corporate form to evade liability null and void, and would require that shareholders who litigate against collection and subsequently lose pay treble damages, including the government's litigation costs. Elective shareholder liability anticipates the development of a derivatives market that would insure shareholders against liability, the price of which would contain more relevant information about risk concentration than is presently available in the capital markets.

Conti-Brown points out the ex ante and ex post benefits of elective shareholder liability. Ex ante, it requires directors and officers who are significant shareholders to increase self-monitoring. Ex post, it creates a fund that can be used to reimburse taxpayers at least partially for the costs of bailouts.

Elective shareholder liability draws on the partnership structure of investment banking that dominated the field throughout its history, until the late twentieth century. That structure provided for unlimited personal liability in the event of bank failure. Though the complexity and size of modern investment banks make a simple return to partnerships unlikely, elective shareholder liability can accomplish some of the same goals.

and, Colin Mayer, Prosperity. Better Business Makes the Greater Good (Oxford: OUP 2018)., suggests a broader social purpose, arguing that non-shareholders are ready to try something different.

21 See Peter Conti-Brown, 'Elective Shareholder Liability' (2012) 64 Stanford Law Review 409.

Conti-Brown's proposal focuses on placing extra liability on those who have the information and power to make the decisions for good or ill. However, by imposing elective shareholders' liability on every shareholder in large banks, this solution may run into exactly the same problem as hit double liability in the US in the 1930s, that is, having to chase up and extract money from many small shareholders, and/or make the return to capital significantly lower on large SIFI banks than on any other public company. Unless one thinks, perhaps for other reasons, that a differential penalty on really big banks is a good idea in any case, then we believe his proposal is less focused and less efficient than our own. Our proposal also allows us to impose sanctions on other bodies with information and power to control companies, which are not shareholders, such as accountancy (audit) firms and credit rating agencies.[22]

A second set of responses, most often coming from legal scholars, aimed more widely at the general governance structure of (public) corporations, has considered such remedies as two-tier governing boards, à la the German system,[23] and changing the statutory duty of governing boards, for example as argued by Schwarcz and Mayer.[24] In the same mode, Kokkinis[25] would seek to impose tougher legal requirements on management. Several of these alternative proposals have involved extending the ambit of the law, either criminal or civil, to cover managerial failings and excessive risk-taking. But taking risks, unless they are spectacularly egregious, is not illegal.[26] Moreover, all too often the managers who have led firms down the garden path to failure have not even appreciated the scale of risks they were assuming or the likelihood of those risks materializing.

22 A Admati, P Conti-Brown and P Pfleiderer further consider changes to the governance of financial institutions in order to decrease the likelihood of taxpayers' bail-outs in the US context. They propose an increased-liability version of the bank's equity via the introduction of a new kind of financial institution: the liability holding company (LHC) which would be subject to a unique regulatory regime supervised by the Federal Reserve. A Admati, P Conti-Brown and P Pfleiderer 'Liability Holding Companies' (2012) 59 UCLA Law Review 852.

23 Sir Vince Cable wondered, 'Could appointing workers to boards fix capitalism's crisis?' in an Opinion article published in City AM on 14 May 2019. See also Cable's speech on 'Capitalism in Crisis', dated 7 June 2018 and available at <https://www.libdems.org.uk/capitalism_in_crisis> in which he explains how a modern, liberal approach can help capitalism save itself.

24 C Mayer, *Prosperity* (Oxford: OUP 2018).

25 Andreas Kokkinis, *Corporate Law and Financial Instability* (Routledge 2018).

26 Ed Kane would define crimes of reckless banking and 'theft by safety net' and prosecute these crimes as vigorously as other forms of bank robbery. He would also recognize and formally monitor taxpayers' equity stake in banks that are too big to discipline adequately and pay dividends on this stake: see 'Ethics versus Ethos in US and UK Megabanking' (2018a) 53 Journal of Financial Services Research 211, and 'Financial Safety Nets: The Good, the Bad, and the Ugly', Essays in Honor of Professor George G. Kaufman for His Lifelong Contributions to the Profession (2018b) *World Scientific* 47.

27 See S Schwarcz, 'Misalignment: Corporate Risk-Taking and Public Duty' (2016) 92 Notre Dame Law Review 1) available at <http://ssrn.com/abstract=2644375>, and 'Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility' (2017) 102 Minnesota Law Review 761 at <http://ssrn.com/abstract=2847026>. See also S Schwarcz, 'Systematic Regulation of Systemic Risk', Wisconsin Law Review (forthcoming), currently available at <https://ssrn.com/abstract=3233666>.

Box 3

Steven Schwarcz argues that limited liability should be redesigned to better align investor and social interests for shadow-banking firms and advocates a public governance duty.[27]

The thrust of his public governance duty proposal is as follows: Market failures encouraging excessive SIFI risk-taking stem from the shareholder-primacy model of corporate governance. Therefore, the most direct way of correcting those failures (and controlling excessive risk-taking) would be to modify that model by imposing some type of a public governance duty that requires SIFI managers to also consider the public consequences of their firm's actions.

Proposing such a duty would engage the longstanding debate whether corporate governance law should require a duty to the public. The accepted wisdom is not to require such a duty because corporate profit maximization provides jobs and other public benefits that exceed any harm. The assumption underlying that wisdom is that any significant public harm would be prohibited by other law or internalized through tort law. That assumption fails, however, for systemic public harm.

Schwarcz examines the merits and design, as well as the possible costs and benefits, of imposing a public governance duty.[28] Such a duty could be performed, for example, by a SIFI's risk committee, including risk committees mandated by post-crisis financial regulation. Most such risk committees, however, are not yet required to consider systemic risk or public harm. For example, risk committees required under the Dodd-Frank Act are only mandated to focus on risks to the SIFI itself, not to the public. Even the guidelines of the Basel Committee on Banking Supervision merely require SIFI managers to 'look after the interests of the bank as a whole' and do not require them to take into account the possibility of systemic externalities.

The thrust of Schwarcz's proposals on how limited liability should be redesigned to better align investor and social interests for shadow-banking firms[29] is as follows: limited liability is not always optimal for firms that make up the shadow banking system. It motivates investor-managers of those firms to take risks that could generate outsized personal profits, even if that greatly increases systemic risk. The law does not effectively mitigate these systemic externalities. Tort law, for example, traditionally helps to mitigate non-systemic externalities resulting

28 The proposed realignment of private and public interests under a public governance duty is different from the regulatory responses to the financial crisis that attempt to mitigate excessive risk-taking by aligning managerial and investor interests. Requiring managers of systemically important firms to account for systemic externalities in their governance decisions would help to correct this misalignment between private and public interests. That, in turn, would help to reduce excessive risk-taking. Managers of systemically important firms should have a duty to society (a 'public governance duty') not to engage their firms in excessive risk-taking that leads to systemic externalities. See S Schwarcz, 'Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility' (2017) 102 *Minnesota Law Review* 761, 787.

29 S Schwarcz, 'The Governance Structure of Shadow Banking: Rethinking Assumptions about Limited Liability' (2014) 90 *Notre Dame Law Review* 1; also available at <http://ssrn.com/abstract=2364126>.

from limited liability by empowering injured third parties to whom the torteasor owes a duty of care to sue for harm that is a causal and foreseeable consequence of the tortfeasor's actions. Systemic harm, however, affects a wide range of third parties in unpredictable ways; it is neither directly causal nor clearly foreseeable. To mitigate systemic externalities, Schwarcz argues that limited liability should be redesigned for investor-managers of shadow banking firms. Any such redesign must balance the need to increase liability sufficiently to reduce systemic risk without discouraging investment. The redesign should also minimize costs by discouraging the need to engage in cross-investor monitoring. These competing goals may well be achievable by restricting the increased liability to a capped multiple of the original investment, such as double liability.

Yet a third, and perhaps the most important, set of proposals, would adjust the link aligning the interest of shareholders and managers by changing the incentive and remuneration terms for management. The general proposal is to require that a proportion of managerial remuneration, particularly for CEOs, are paid in a way that will fall in value, or disappear entirely, should the firm fall into loss and/or default. This is the approach most commonly taken by economists, rather than lawyers. A recent example is a paper and proposal by Tom Huertas, entitled 'Pay to Play',[30] which proposes that a significant proportion of senior management remuneration be paid in bail-inable bonds. Acharya and others have suggested that remuneration be paid partly in deferrable cash payments.[31] They argue that this would be better than paying in (bail-inable) debt, because the cash would revert to the bank in times of stress. In their view, deferred cash would be better than deferred equity-linked claims, on the grounds that equity-linked claims still benefit from increased volatility. They further argue that their proposal would be better than putting more weight on CoCos (Contingent Capital), since the latter is a contingent liability of the bank, whereas cash would be a contingent asset. Bhagat proposes that the incentive compensation of senior executives should consist only of restricted equity.[32] Bolton, Mehran and Shapiro[33] would relate compensation not only to the stock price, but also to the credit default swap (CDS) spread, so that compensation would decline as spreads rise. The presumed advantage of this would be that it is an ex ante market price which should, in principle, react to additional risk as it occurs. A practical problem with that is that the experience of the great financial crisis suggests that CDS spreads are not a good predictor of developing risk, but when

30 Thomas Huertas, 'Pay to Play' (17 February 2019), available at SSRN: <https://ssrn.com/abstract=3336186> (revised May 2019, now entitled 'Rebalance bankers' bonuses: use write-down bonds to satisfy both supervisors and shareholders').

31 See Viral V., Hamid and Rangarajan K. , 'Cash Holdings and Cash Compensation' in FRBNY, *Economic Policy Review*, Vol 22, No 1, 'Behavioral Risk Management in the Financial Services Industry' (August 2016). See also in that same review the article by Hamid and Joseph, 61–75.

32 See Sanjai Bhagat, 'Thoughts on How Bank Executive Compensation should be Reformed', RealClear Markets, 11 March 2019, <https://www.realclearmarkets.com/articles/2019/03/11/thoughts_on_how_bank_executive_compensation_should_be_reformed_103655.html>.

33 Patrick, Hamid and Joel D., 'Executive Compensation and Risktaking' (2015) 19 Review of Finance 2139.

such risk does emerge, the reaction of such spreads is extremely sharp, so that there would have been a huge discrepancy between compensation payments made just before and after the onset of the crisis. A common feature of this final set of proposals, on which there is now a large literature, is that a proportion of managerial, especially CEO, remuneration is paid in a form that can be reduced, or eliminated entirely, should there be loss, misconduct or default.

On a somewhat different tack a somewhat different track, Calomiris and Herring[34] have advocated requiring all public corporations (or a sub-set) to issue convertible contingent debt in such a large volume that it would dilute existing shareholdings massively, when triggered; this trigger would be a fall in the market price of the corporation, but it should remain at a sufficiently high value to indicate that the corporation is still clearly viable. The great advantage of this proposal is that it would encourage existing shareholders to put pressure on management, for example by changing the form of their remuneration, to avoid risky activities that might endanger the company.

Instead, our proposal, set out in section III, is to move to a system with two classes, or tiers, of equity holders; namely 'insiders' with additional information about, and power to influence, managerial decisions, and 'outsiders', those without such powers. There are already distinctions in some cases between shares with voting rights, and those without; and there are many tiers of debt obligations. One of the main problems of unlimited, or multiple, liability was that it seemed unfair, and politically unacceptable, to penalize 'outside' shareholders, especially retail individual investors who had little knowledge of, and no power to influence, the policies that had led to the bad outcome.

One advantage of this proposal is that it might be capable of extension to auditing firms and credit rating agencies (CRAs), even though they do not hold shares in the firms that they audit/rate. Also, such a two-tier system could/should allow fines for corporate misconduct to be applied solely, or primarily, to 'insider' shareholders, and not imposed (inappropriately) on all shareholders, including 'outsiders'. This would not only be much fairer, but also have a stronger, and more direct, incentive effect on management to prevent misconduct. This is discussed in section IV.

Indeed, one of the purposes of the exercise is to restore a sense of fairness with respect to the costs and benefits facing individuals placed in different circumstances. When a financial crisis involving a corporate insolvency occurs, many 'smaller' people, such as workers, trade creditors and small investors, may lose a lot, whereas it often appears that the senior managers of the financial institutions at the heart of the crisis walk away relatively unscathed. Even if the managers did nothing wrong in a legal sense, neither did the smaller people who got hurt. In our view, the political uproar following the great financial crisis was not caused so much by the State stepping in to bail out the

34 CW Calomiris and RJ Herring, 'How to Design a Contingent Convertible Debt Requirement that Helps Solve Our Too-Big-to-Fail Problem' (2013) 25(2) Journal of Applied Corporate Finance 39.

institutions, but rather by the fact that the private sector managers, who were largely responsible, were not subject to much heavier sanction.[35]

In section V we compare and contrast the main alternative proposals, set out above in section II, with our own proposals.

Section VI concludes.

III. OUR PROPOSAL FOR A TWO-TIER EQUITY SYSTEM

Thus, our proposal is to apply a distinction between a class of 'insiders', who should be subject to multiple liability, and 'outsiders', who would retain limited liability, as at present.[36] For the ordinary shareholder there would be no change. Such a scheme obviously involves making a distinction, which must be inevitably somewhat arbitrary, between 'insiders' and 'outsiders'. We discuss below how such a border might be defined, and such other calibrations as might be necessary. There is, to be sure, a particular problem with respect to (large) institutional investors. Sometimes they choose to behave passively, as if 'outsiders' and sometimes they engage actively with management, as if 'insiders', and they can even switch from one role to the other. We propose in this respect a mechanism for institutional self-selection.

But how do you distinguish between these two categories? In principle, the distinction is straightforward. 'Insiders' have access to significantly greater information about the working of the enterprise than 'outsiders', and the potential to use that information to prevent excessively risky actions. In practice, of course, the distinction is not so easy to make. 'Insiders' would include all of the Board of Directors, including the externals. For employees, we suggest a two-fold categorization, by status within the company, and by scale of remuneration. Thus any employee on the Executive Board, or who is Chief of a Division would be included. But the key players in a company are frequently indicated by the scale of their remuneration rather than by their formal position. So any employee who is earning a salary in excess of, say, 50 per cent of that of the CEO, would also be assessed as an 'insider'. Nevertheless, if the potential sanction of multiple liability arising from failure is regarded by employees as severe, there could be attempts to adjust titles and salaries so as to avoid being categorized as an 'insider'. So, the regulatory authority should have the right to designate anyone in a particular company as being an 'insider', subject to judicial review. The Prudential Regulation Authority (PRA)/FCA under the Senior Management and Certification Regime (SM&CR) already requires banks to allocate all the designated responsibilities and to set these out in a 'responsibilities map'.

35 It is also possible to impose financial consequences on management via sanctions. However, as we further discuss below, a major problem is that the imposition of sanctions by regulatory bodies—in itself a time consuming exercise—has led in the UK to very few and generally small fines on individuals, notwithstanding the introduction of the Senior Management and Certification Regime (SM&CR).

36 Heny Hansmann and Reinier Kraakman, 'Towards Unlimited Liability for Corporate Tort' (1991) 100(7) The Yale Law Journal 1879 argue in favour of a distinction based on type of liability from the perspective of tort law. David Campbell and Stephen Griffin, had the same general idea as the proposal described in this article, but their outline of how it might work was extremely sketchy: David Campbell and Stephen Griffin, 'Enron and the End of Corporate Governance' in S MacLeod (ed), *Global Governance and the Quest for Justice* (Hart Publishing 2006) 47. Also see Kevin Dowd, 'Let's Give UK Banks Choice' in *What a Capital Idea* (Adam Smith Research Institute 2019) 40.

The bank board must sign off on this, thus ensuring that there are no over or underlaps and that the allocations are appropriate.

Large shareholders are also in a position to access inside information, and to exert influence on the course that a company might follow. So any shareholder with a holding greater than, say, X per cent of the company, should also be regarded as an 'insider'. There is no obvious particular key threshold, above which a large shareholder should be regarded as an 'insider', so there remains a question regarding what value X might take.[37] In particular, institutional shareholders vary in the degree to which they prefer to be active, or passive. It is arguable that one should give shareholders, notably institutional investors, holding between 2 and X per cent of the value of the shares the ability to choose whether to be regarded as an 'outsider', or as an 'insider'.[38] If they want to be treated as an 'outsider', they would have to undertake not to exercise voting rights, and not to participate in policy discussions, for example at the annual general meeting. They should be allowed to change their preferred designation, but only after a period of notice, say three months.

The base to which the liability should apply would be the remuneration of all those counted as 'insiders' (dividends in the case of large inside shareholders), cumulated from the date that they took on that role. This would apply to all forms of remuneration (above a basic wage), except those provided in the form of bail-inable debt, with all subsequent transactions in such debt having to be notified. This would apply to the directors and employees. Since the sanction would only apply to remuneration received after becoming an insider, (institutional) investors would risk relatively little if they perceived a company in which they may have invested going in the wrong way and they wanted to force it to change direction. After such an issue was settled, the (institutional) investors could switch back to outsider status. Indeed the insider/outsider balance among a company's shareholders would become an indicator of concern about its governance and strategies. It would also be necessary to codify that the insider status in the above sense did not imply that institutional share trades would be subject to insider trading limitations.

Not all 'insiders' are equal. In particular, the CEO has much more information and power than any of his subordinates, other members of the Board, or the auditors. The CEO's liability could be, for example, three times the accumulated relevant value of remuneration (ex bail-inables) from the time that the individual had taken up the role of CEO. Board members and chief officers of the company might then have two-times liability, and every other 'insider' employee a single liability equal to their accumulated revenue (note that non-executive directors often receive little remuneration, so their accumulated liability would be commensurably small). Similarly, large shareholders

37 Some huge shareholders, such as sovereign wealth funds, almost necessarily, hold several per cent of the shares of all large public companies. The threshold would need to be high enough to prevent these becoming automatic 'insiders'.

38 In his comments on this article, Rafael Repullo pointed out the challenge that the growing importance of passive institutional investors presents for our proposal. Indeed, the question of the treatment of large shareholders with considerable potential power over the strategy of the corporation is the area where there has been most push-back.

with greater than X per cent holdings might have double liability, and also 'insider' shareholders, between 2 and X per cent.

The mechanics of such a two-tier system might be, however, quite complex. This is particularly so because we envisage the financial penalty on 'insiders' kicking in when loss or misconduct occurred, and not just in the event of insolvency and closure. We raised this issue in the presentations of our proposals, and, fortunately, we received several helpful suggestions in this respect. In particular, we thank Peter Sinclair for the following outline proposal:[39]

> All bonuses to 'insiders'[40]—plus some fraction (half?) of stipend—should be paid into a fund and translated at once into special shares. Dividends on these—whether positive or negative—would be added to or subtracted from the value of holdings. In the event of insolvency, the company would at once become a senior creditor and automatically receive these holdings with no compensation. Board members' bonuses and emoluments would be treated the same way. After the individual's removal from the board, or from any position with the company, she would be entitled to sell the special shares at fair market price to the company, but only after N days. (N might be 1000.) The special shares would be non-transferable, until that date.
>
> Suppose the company has issued a total of M shares, whether ordinary, preference or special. Let its total equity valuation be £X today. A special share would be valued at £X/M. Its dividend would be proportional to its total after tax profits, whether negative or positive, the factor of proportionality being D/M. D would be an economy-wide long term average distribution ratio for after-tax profits (say about half). If the company made losses, the dividend would be negative, and enforced through an equivalent cancellation of some fraction of outstanding special shares; positive profits would lead to a corresponding increase in the number of special shares, in the form of a mandatory rights issue.
>
> Any existing shareholder would be entitled to acquire or sell special or ordinary shares. Ordinary shares enjoy some shock-absorption, because of dividend smoothing. Special shares would be unsmoothed. The absence of any potential pay-out in the event of insolvency, coupled with the greater risk, would mean that special shares would probably trade at a small discount against ordinaries. The company would have an interest in keeping that discount low by buying back such shares from departing insiders at a fair value.
>
> Choice variables include N, but also the fraction of regular stipend paid in the form of special shares. Also the same fraction (50%? 100%) of pension contributions for CEO, board members and senior executives should be paid in the form of non-transferable special shares. Again any excess employee remuneration over say 20 times average FT-equivalent employee pay could be paid as non-transferable special shares.[41]

39 Personal communication. See also, P Sinclair, 'Advantages and Drawbacks of Bonus Payments in the Financial Sector' in G Caprio, P Bacchetta, J Barth, T Hoshi, P Lane, D Mayes, A Mian and M Taylor (eds), The Handbook of Safeguarding Global Financial Stability (Academic Press 2012) 259.

40 Dividends to 'insider' shareholders.

41 See John Thanassoulis and Misa Tanaka, 'Optimal pay regulation for too-big-to-fail banks' (2018) 33(c) Journal of Financial Intermediation 83. See also P Sinclair, 'Advantages and Drawbacks of Bonus Payments in the Financial Sector' in G Caprio, P Bacchetta, J Barth, T Hoshi, P Lane, D Mayes, A Mian and M Taylor (eds), *The Handbook of Safeguarding Global Financial Stability* (Academic Press 2012) 259; and Guy Spier, Tom Skinner and Peter Sinclair, 'Bonuses and the Credit Crunch' in D Mayes, R Pringle and M Taylor (eds), *Towards a New Framework for Financial Stability* (Central Banking 2009) 837.

Another suggestion was to make more use of uncalled capital while a bank was still a going concern, as was widely done in the years up until 1914 (as suggested by Grossman and Imai,[42] also see the Appendix to this article). Instead of special shares, bonuses and parts of stipends could be paid in uncalled capital.[43] Then, one could proceed as outlined by Sinclair.

Meanwhile Simon Watkins of the FCA asked whether the same outcome as multiple liability could also be achieved through a derivative, which all 'insiders' would be required to hold. This would impose a loss—a necessary repayment—in the event of loss or insolvency of the company. In the case of Sinclair's proposal, or the uncalled capital suggestion, at least much of the remuneration would be automatically clawed back, even if there might be problems in collecting the higher multiples. But with such a derivative, avoidance or evasion might be more difficult to tackle.

Clearly the mechanism could be quite complex and needs further thought.[44]

There are then two further questions. The first is what should happen when an 'insider' ceases to play that role, for example when an employee leaves the company or a large shareholder sells its shares. The second is that an 'insider' may be aware that the company is entering dangerous territory, but cannot persuade management to change direction. In that case, how could insiders avoid being sanctioned for a policy that they would not themselves advocate?

In the first case, that is, departure from the role of 'insider', it would seem appropriate to taper the liability according to the degree of 'insider' knowledge and power. Thus, if it was agreed that the CEO should have 'three times' extra liability, then that liability would decline at a constant rate over the following three years, leaving the CEO with zero further liability exactly three years after departure. By the same token, the liability of those with 'two times' additional liability should taper at a constant rate until they were free of any further liability after two years, and those with 'one time' additional liability should be free of liability after one year.

Then we come to the second issue, which is the question of how those with additional liability can avoid sanction in those cases where they have opposed a certain policy, but have failed to succeed in changing it. Our suggestion is that those in such a position should address a formal, but confidential and private, letter to the relevant regulators, setting out their concerns about the policy being followed. The regulator would have to formally acknowledge receipt of such letters, which could then be used in mitigation, or even abandonment, of any sanction should the company then fail. Moreover, in the event of the company failing for the reasons indicated in such a letter

42 See Richard Grossman and Masami Imai, 'Contingent Capital and Bank-Risk Taking Among British Banks before the First World War' (2013) 66(1) Economic History Review 123. At 138 they explain that the Companies Act 1879 instituted the principle of 'reserve liability'. Section 5 of the Act allowed banks to divide their uncalled capital into two parts, one to be callable at the discretion of the directors and a second as reserve liability only to be called up in the event that the firm was wound up. Making use of uncalled capital could ensure that inside shareholders bear a greater share of losses as well as seeking to stabilize a bank in distress but before it has actually failed.

43 This version obviously links closely to the proposal of Huertas (n 29) for 'Pay to Play', now entitled 'Rebalance bankers' bonuses: use write-down bonds to satisfy both supervisors and shareholders'.

44 We thank one of our anonymous referees for pointing out this need.

(or letters), this would in turn act as a form of accountability for the regulators. All such letters would have to be made publicly available in the event of failure. It would be a legal offence for the regulator not to publish any such letter at that time.

There is a more difficult question: whether the regulator, having received a private confidential letter of warning—perhaps from the auditor or an unhappy employee—should make it public immediately. In our view, such warnings need to be investigated further by an independent body, such as the regulator or a financial ombudsman before being made publicly available, since in many cases they may be groundless, with the maintained policy of the company being appropriate. But if the regulator, after investigation, felt that the warnings had merit, the first step would then be to have a private discussion with management on the merits of the case. If management remained unmoved, the next stage would be to publish the warning (anonymously), together with the regulator's own assessment, while at the same time offering management the opportunity to state publicly its own view. Once this latter process had been completed, 'outsiders' would be as well informed as 'insiders' on the merits of the issue.

Note that this would put regulators in the firing line for at least severe reputational damage if they received such warnings, failed to act upon them, and the warnings proved prescient.

The purpose of the exercise would be to provide appropriate sanctions for failure on those with 'insider' knowledge and power. The particular illustrative numbers chosen in the above discussion are, obviously, somewhat arbitrary. But the exercise could be calibrated to impose appropriate sanctions for all such 'insiders', whether they are large shareholders, key employees, or regulators. We think that this would be a better form of governance.

This approach does not, we believe, leave us open to the Friedman criticism that it completely severs the interests and incentives of the agent (the manager) from that of the principal (the equity holder). The remuneration of both remains totally aligned under our proposal, so long as the company is profitable. It is only in instances of bad outcomes, especially bankruptcies, that the sanction on the managers/insiders becomes more severe than that on the outside equity holders. The aim is to reduce the risk of such bad outcomes being shifted to others, such as employees, creditors, taxpayers, and, via various externalities, to the economy more widely.

While we would hope, and indeed expect, that greater pecuniary sanctions on inside equity holders, notably managers and CEOs, would significantly reduce excessive risk-taking and bankruptcy,[45] history clearly reveals that unlimited liability did not prevent large scale and systemic occasions of failures. There were major incidences of bank failures, primarily among unlimited liability country banks, in 1825, 1837, and 1847,[46] and, of course, it was the failure of the City of Glasgow Bank in 1878, with its widespread holding of outsider-type unlimited shareholdings, that led to a general transition of banks from unlimited to limited liability. Irrespective of the sanctions involved, most

45 Felipe Aldunate, Dirk, Arthur and Peter, 'Shareholder Liability and Bank Failure' (forthcoming), demonstrate that in the USA, 1929–33, double liability (DL) State banks were some 10–15 per cent less likely to get into distress than single liability State banks.

46 Sir John Clapham, *The Bank of England: A History* (CUP 1970). See Volume II, Chapters II, III and IV.

humans are unduly optimistic about their own skills and ability (some 90 per cent of car drivers believe they are in the top 50 per cent of driving ability Ola Svenson, (February 1981). 'Are We All Less Risky and More Skillful Than Our Fellow Drivers?' Acta Psychologica. 47(2): 143–148). Moreover, systemic failures frequently arise as a result of a general incapacity to assess risk correctly.

Thus it is, perhaps, more common for failure to arise as a result of an invalid appreciation of probabilities, rather than a conscious assumption of additional perceived risk. This, in turn, means that in many cases that there was no intention (*mens rea*) to put the company (ie, the bank) into a position of excessive risk. Dick Fuld did not think that building up a massive holding of mortgage-backed securities was risky, nor did Fred Goodwin appreciate the risks involved in the Algemene Bank Nederland (ABN) and Amsterdam-Rotterdam (AMRO) Bank merger. But if in many, perhaps most, cases there was no conscious intention to risk the bank or any moral blame, in the sense of knowingly taking on an exposed position, then there can be no effective basis for a legal sanction. In that sense, the pecuniary sanction that we are proposing is not itself based on any moral, or indeed legal, basis. But note that corporate failures also impact adversely on many stakeholders who are clearly and certainly blameless. What really upset people in the aftermath of the great financial crisis was that many innocent bystanders, including homeowners who had their homes repossessed, bank employees, and taxpayers, were damaged, sometimes seriously, whereas the leading bankers appeared to walk away with their accumulated wealth and forthcoming pension rights entirely unaffected. This was perceived as extremely unfair.[47] One of the main purposes of our proposal is to restore a sense of balance, and fairness, between the sanctions imposed on bankers as compared with those imposed on other stakeholders; and such a sense of balance needs to be, in some large part, independent of the intentions of the corporate (bank) managers, whose intentions in any case would be extremely hard to discern in a court of law.

There might, just possibly, be room for an extension of our proposal. In recent decades, regulatory bodies (as well as the Department of Justice in the US) have taken to imposing large fines on corporates when corporate activity is perceived as having been wrongful, for example, the Deepwater disaster for BP, and also imposing fines on banks for allowing money laundering and evading sanctions. But such fines primarily fall on outside shareholders, who had no involvement whatsoever in the actions undertaken, and they also deplete the capital buffers of corporates, often just at the time when these buffers are most needed. What would be desirable, if it could be done, would be to redirect such fines solely to the segment of inside shareholders, as defined above. It is the shareholders who have control over decisions who should be fined for wrongful activities, not the generality of outside shareholders.[48]

47 For a discussion on the political consequences of such perceptions, see Jeffrey M. and Andrew, *The Wealth Effect* (CUP 2019).

48 Judge Jed Rakoff stated:

> 'And from the moral, punishing a company and its many innocent employees and shareholders for the crimes committed by some unprosecuted individuals seems contrary to elementary notions of moral responsibility.'

There have been some moves in the general direction that we propose in this article. In particular the adoption of the Senior Management and Certification Regime (SM&CR) in the UK is a step in the right direction. The SM&CR, introduced in the UK in December 2013, had several aims.[49] It was seen by the Parliamentary Commission on Banking Standards as a device that could pierce through what its report repeatedly referred to as an 'accountability firewall' that had hitherto made it hard for senior managers to be held responsible for their failings. Parliament wanted a completely new regime that would ensure 'senior managers of banks [would] no longer be able to hide behind an accountability firewall, where they are too distant from the consequences of their responsibilities to be held directly accountable when things go wrong'.[50] To regulators, the SM&CR was seen as a framework that would enhance accountability at the highest level of regulated firms, targeting individuals—as opposed to institutions—and also enable more effective enforcement action. Fundamentally, however, in view of the thesis advanced in this article, the SM&CR presents an opportunity to 'internalize' the costs of misconduct so that these costs fall on the very individuals involved in reckless behaviour or excessive risk-taking, rather than on innocent bystanders (eg, creditors, customers who lose their money, and taxpayers). Furthermore, the SM&CR could have potential as a deterrent against 'externalizing' the costs of misconduct to shareholders (where failure results in hefty penalties on the firm) or to taxpayers (when misconduct results in failure that imposes costs on taxpayers).

However, the jury is still out on how effective the SM&CR has been. This can be explained by a number of factors. First, while the SM&CR legislation was enacted in December 2013, the framework only initially started in March 2016. In 2017 it was extended to all financial firms in the UK, a process that has been ongoing through 2017/18, and has now drifted to the end of 2019. One could rightly argue that there has not been sufficient time to test SM&CR's efficacy through enforcement and judicial actions, other than the whistleblowing case involving the Barclays Bank chief executive.[51] Secondly, the framework that is being rolled out today is slightly different in a few but important areas, compared to what the PCBS had recommended in 2013. Notably, the shift from a situation where a senior manager could have been forced to defend against regulatory action by evidencing the actions that the manager took to prevent failure, to the current situation where the onus is on regulators, may have partly contributed to the limited enforcement action, due to the time it takes to undertake investigations needed to support successful sanctions. Be that as it may, at the end of 2018 the press was full of comments regarding how low the application of fines and other sanctions had been. Therefore, our contention is that the SM&CR does not go

In JS Rakoff, 'The financial crisis: why have no high level executives been prosecuted?', *New York Review of Books*, 9 January 2014, available at <https://www.nybooks.com/articles/2014/01/09/financial-crisis-why-no-executive-prosecutions> assessed 9 May 2018.

49 On this see Oonagh McDonald, 'Holding Senior Bankers to Account' in *Holding Bankers to Account* (Manchester University Press 2019) ch 10.

50 Parliamentary Commission on Banking Standards (PCBS), *Changing banking for good* (HC 175-II, 2013) 489.

51 Financial Conduct Authority, Final Notice 11 May 2018 (reference JXS02208) para 2.9.

nearly far enough. It is a start; but our proposal would represent a major extension of the concept that penalties for failure should fall primarily on those with a controlling voice taken (strict liability).[52]

There is also the issue faced by the PRA and FCA of attempting to impose sanctions on senior management based outside the UK. This issue arises because of the way many banking groups operate, with key functions and individuals based in other jurisdictions. The legal structure of the bank and its actual operational organization rarely coincide.

If the pecuniary sanctions imposed on insiders were to be severe—and the suggestion that CEOs might be made to face unlimited liability would no doubt be seen as severe—then there would surely be attempts to avoid or evade such sanctions. One of the claims that would be made is that this would significantly reduce the supply of qualified people prepared to take on senior management positions. As always, when any significant sanction on failing managers is proposed, the counter-claim is made that no one would be prepared to take up such an (insider) role. We very much doubt whether this particular claim has much merit. It is hard to show that, during earlier periods when the norm was unlimited liability, there was a shortage of candidates for a senior bank and corporate position. The attractions of power,

52 A number of recent publications have discussed the issue of imposing no-fault or strict liability (that is, liability without fault or irrespective of fault) on senior management. This literature, which draws on criminal law and tort law, provides some insights into the understanding of personal accountability. See generally Paul Robinson, 'Strict Liability's Criminogenic Effect' (2018) 12 Criminal Law and Philosophy 412; Luke Price, 'Finding fault in organisations—reconceptualising the role of senior managers in corporate manslaughter' (2015) 35(3) Legal Studies 386; Reinhard Zimmermann, 'Damages and Interest' in Nils Jansen and Reinhard Zimmermann (eds), *Commentaries on European Contract Law* (OUP 2018) 1436; George R Skupski, 'The Senior Management Mens Rea: Another Stab at a Workable Integration of Organizational Culpability into Corporate Criminal Liability' (2011) 62(1) Case Western Reserve Law Review 270. The need to focus on punitive action against individuals rather than solely on legal entities has also resulted in a raft of strict liability legislation across EU states, though these have largely been implemented via existing criminal law and procedures. See Katalin Ligeti and Angelo Marletta, 'Introduction' in Katalin Ligeti and Angelo Marletta (eds), *Punitive Liability of Heads of Business in the EU: A Comparative Study* (Wolters Kluwer 2019) 1.Philip Rawlings, Andromachi Georgosouli and Costanza Russo argue in a QMUL 2014 report on 'Regulation of Financial Services' (available at <https://www.qmul.ac.uk/ccls/media/ccls/docs/research/020-Report.pdf> 44) that though generally, regulatory offences impose strict liability—thus requiring proof of the act but not of an intention to commit the act—on companies, 'nevertheless, as part of the enforcement-led approach, which was introduced in the wake of the financial crisis, the attempt has been made to hold senior company officers accountable'. Kayleen Manwaring and Pamela Hanraha, 'BEARing responsibility for cyber security in Australian financial institutions: The rising tide of directors' personal liability' (2018) <https://ssrn.com/abstract=3284289> 23 explain that the Australian financial services regulator can bring civil penalty proceedings 'against individual directors, including non-executive directors' and that this type of action does not require that the regulator establish 'any level of culpability on the part of the individual director'. John Armour and Jeffrey Gordon (n 5) 64 and 68 have proposed a negligence-based standard of liability for directors to induce board 'ownership' of the firm's risk, so that the board will take charge of understanding the level of risk-taking, and, where necessary, curb it. (They also refer to Delaware General Corporation Law, s 102(b)(7) which provides directors with a liability shield for breach of duty of care, exculpating them from most failures.) Christian Witting, 'Modelling Organisational Vicarious Liability' (2019), Legal Studies, SLS, p 2, notes that '[t]he imposition of strict liability on senior managers or directors creates incentives to be proactive in setting standards of conduct'. Finally, David C Viadeck, 'Machines without principals: Liability rules and artificial intelligence' (2014) 89(1) Washington Law Review 147 argues that 'a predictable liability regime may better spur innovation than a less predictable system that depends on a quixotic search for, and then assignment of, fault'.

prestige, and wealth that accompany a senior management role, in particular that of CEO of a major company, will always attract many candidates. Indeed, one might even consider the possibility that an appreciation that failure could lead to penury might even lead to a better class of candidate being prepared to assume corporate leadership. Moreover, as Simon Gleeson (Personal communication. See also, Simon Gleeson, Macroeconomic regulation: new regulators, new powers, Capital Markets Law Journal, Volume 4, Issue suppl_1, July 2009, S99–S111.) pointed out to us, the extra risk of multiple liability would likely mean that those affected could claim, and receive, higher remuneration during good times. Since senior managers are generally self-confident, this proposal could ex ante receive the backing of both managers and supervisors.

Box 4

An interesting precedent is provided by the Companies Act of 1948 ss 202 and 212. According to s 202 (which survived into the Companies Act 1985 as s 503), 'in a limited company the liability of the directors or managers, or of the managing director, may, if so provided by the memorandum, be unlimited'. Section 212, the enforcement provision, (which became s 503 of the Companies Act 1985, and, shortly after that, s 75 of the Insolvency Act 1986) provided a free-standing mechanism for enforcing this liability: a director or manager with unlimited liability 'shall, in addition to his liability (if any) to contribute as an ordinary member, be liable to make a further contribution as if he were at the commencement of the winding up a member of an unlimited company'.[53] This section was repealed from 1 October 2009 by the secondary legislation introducing the Companies Act 2006,[54] which appears to confirm that the abolition must have been part of the 2006 reforms.

This historical precedent constitutes a working example of a structural incentive which avoided one of the main drawbacks of unlimited liability, namely that it is very imperfectly targeted. It was probably dropped by the Company Law Review on the ground that it was never used. As Guy Morton notes, if so, that does not necessarily prove that it was a bad idea—merely that it was unattractive to a group of people (ie, prospective managers) who exercised a dominant influence over the structure chosen for institutions. In fairness to those people, though, the unlimited liability of managers had the additional drawback of being 'all or nothing' and contained no mechanism for tempering liability by reference to culpability, so they can hardly be blamed for shying away from it.[55]

53 Thanks to Guy Morton for observations on this point.

54 Companies Act 2006 (Consequential Amendments, Transitional Provisions and Savings) Order 2009 (SI 2009/1941), arts 2(1), 8, Sch 1 para 75(4).

55 Thanks to Guy Morton for observations on this point.

There is at least one surviving UK bank with unlimited liability—C Hoare & Co—which is an unlimited company and the shareholders are also the managers.[56] C Hoare & Co prides itself in having a conservative and personal ethos and in encouraging a long term outlook for their customer relationships and business decisions—one that tries not maximize profits, but to optimize quality. Their purpose is 'to be good bankers and good citizens'.[57]

The knowledge of unlimited liability prompts partners to be cautious about the criteria and process for admission to partnership (this is still how many law firms structure themselves), and to aim for dual or multiple oversight of very large and complex matters.[58] But in this context unlimited liability can have very harsh effects, particularly in cases of partner fraud. (The example of Sir Walter Scott, who spent the latter part of his life writing to pay off creditors of a firm of which he had been a sleeping partner, provides a cautionary note.)

There would also be other avoidance measures undertaken, or at least threatened. One such measure would be to shift the country of incorporation to one where limited liability for all still remained. That could be prevented, or at least offset, by requiring any organization with a large-scale operation in the UK to do so in the form of a separately capitalized subsidiary, where the managers of that subsidiary would, in turn, be subject to multiple liability. A second possibility would be to try to avoid such sanctions by taking out insurance, for example in the form of an extended version of the present directors and officers insurance. But we are not particularly concerned about that possibility. It would, for example, be impossible to insure a condition of unlimited liability, and the prospect of multiple liability would lead to the premia needing to be paid for such insurance to become extremely high and, in turn, would lead the insurance company involved to be desperate to monitor riskiness, and to withdraw insurance at the first sign of trouble ahead. Finally, those subject to multiple liability could try to avoid the penalty, for example by short selling the equity of their own company or by shifting their wealth to other family members or close friends. A wider distribution of wealth would put such great strain on family and friendship links in the event of failure

56 C Hoare & Co is the oldest bank in the UK and has maintained close family ownership of the firm since the seventeenth century. Five of the board directors are members of the same founding family. They and two other family members, are the only shareholders. They are known as 'partners' and each has unlimited liability. <https://www.hoaresbank.co.uk/sites/default/files/styles/CHC%20Cons%20Accounts%202018_Signed.pdf>. The bank is very small operating in a niche very high-net-worth market and conservatively run, in terms of capital, liquidity and lending practices. It has only 371 employees with two branches (as of 31 March 2018). The bank's Common Equity Tier 1 ratio of over 21 per cent is significantly higher than the average of the large UK banks (which are structured as PLCs). The bank keeps a significant part of its assets at the Bank of England (£1.2bn, just over 25 per cent of all its assets). Almost all the other assets consist of loans to customers (£3.3bn).

57 We thank Alexander Hoare, CEO of C Hoare and Co, for observations on this point.

58 The extent to which the abandonment of the traditional partnership structure by the major US investment banks (the last to become incorporated as a public company being Goldman Sachs in 1999) contributed to shifting industry expectations as regards levels of remuneration and risk-taking is a subject which deserves further study.

that the principals involved would only be prepared to shift wealth up to a point. In any case, as noted earlier, we doubt whether managers often have the ability accurately to foresee the probability of their own subsequent failure. So, to conclude, while there would certainly be avoidance measures taken, we do not think that these would be so extensive and successful as to limit or abrogate the purpose and value of the proposal that we make, which would need to be statutorily mandated.

The changeover from unlimited liability to limited liability towards the end of the nineteenth century was a relatively slow process, taking decades, depending in some large part on experience. While we believe that a generalized shift to a two-tier system of equity liability is the ultimate objective towards which we should strive, doing so in one huge jump would be impractical. There would be insufficient prior experience of how such a system would work; the political opposition would be great, even if patently self-interested; and the transitional costs might be very large, and would be unknown in advance.

So we would suggest introducing such a reform on a more gradual basis, starting with the sector where it seems most appropriate. In this respect we would take a leaf out of Peter Conti-Brown's proposal (see Box 2). He suggests making SIFIs subject either to much higher capital requirements or making *all* shareholders subject to unlimited liability. But the weakness of his proposal is the unfairness—and political unpopularity—of bankrupting innocent, uninformed, and powerless outside shareholders. What we would suggest, instead, is to give such SIFIs the alternatives of much higher capital requirements, or adopting a two-tier equity system along the lines outlined above. Only the SIFI's CEO might then have unlimited liability, but other insiders would have multiple liability along the lines outlined above.

If this experiment was successful, then it could be extended, to other financial institutions, such as insurance undertakings, and also to FinTech companies.[59] But, ultimately, we hope that it could be applied to all public corporations whose outside shareholders enjoy limited liability protection.

IV. SOME EXTENSIONS

Additional categories of 'insiders' could be the auditors of the firm and its CRAs (even though these are not shareholders). In both cases, auditors and CRAs have privileged access to insider information, if they so want, and they provide publicly available information on which investors and counterparties rely. If they take an unduly optimistic view of the prospects of a firm, possibly because they are influenced by the fact that they are remunerated by that firm, then this needs correction and should be subject to sanction. The auditors might have liability equal to twice their accumulated revenue from the failing firm,[60] with the same taper on replacement and ability to warn the regulator privately as already described.

59 We thank one of the anonymous referees for observations on this point.

60 A letter from Tim Sutton in the *Financial Times* (28 February 2019) argued that 'This would not deter sloppy auditing. The audit firm rather than the audit partner would bear the cost and it's likely the firm would simply take out insurance against this risk . . . Arguably, the most potent provisions of Sarbox relate to top managers' responsibility for financial statements . . . Sarbox requires the officers who sign the company's accounts (ie the chief financial officer and chief executive) to certify that the accounts do not contain misrepresentations

Devising appropriate sanctions for CRAs is considerably more difficult. What they do is offer an ordinal ranking of credit default risk. The concern is that a CRA may be excessively prone to optimism, because of a bias related to the CRA being remunerated by the firm being rated. The ill effect of any such optimism would be seen by the CRA maintaining an excessively high rating, such as AAA, almost up to the very date of default. One approach would be to look at three dates prior to the announcement to default, for example two weeks prior, four months prior and one year prior. If the rating was above D two weeks prior, or above B- four months prior, and above A- one year prior, then the CRA involved could suffer a sanction. That sanction could be further calibrated to be more severe, the higher above the trigger level the rating remained at each date. The point of the exercise is to try to ensure that CRAs react reasonably promptly to any worsening in their firm's conditions sufficiently far in advance to provide a reasonable warning signal. Admittedly this could cause a hair-trigger problem, with rating agencies rushing to protect themselves against penalties as difficulties become apparent, and thereby worsening confidence. The calibration in this case might be quite complex, but might be feasible. This problem deserves more thought.

A further extension might relate to the imposition of (judicial) fines on companies for bad behaviour. At present the fine is levied on the company as a whole, thereby reducing the residual value of the company, and the market value of all shares. Thus the fine is effectively imposed on all shareholders. But, for example, outside shareholders in BP, which undertook a risky form of drilling in the Gulf of Mexico, or Danske Bank, which became involved in a money laundering scandal, had no knowledge whatsoever, nor power to influence the decisions that led to such bad behaviour. So, the innocent are being punished for crimes for which they are guiltless. Furthermore, the fine weakens the capital value of the firm involved, often at just the time when it needs a larger buffer to survive under adverse circumstances.

A much better way of proceeding would be to levy such fines only on insider shareholders. Almost by definition, such insiders should have had the information and power to affect the decisions that led up to the bad behaviour. Even in those frequent cases where some insiders did not have the information, the threat of more focused penalty would make the insiders concerned to enhance risk management and compliance. Admittedly the scale of such fines would have to be lessened, because the available wealth of the insiders is more strictly limited. But the purpose of such fines should never be to provide fiscal support, but rather to deter such bad behaviour in future. The more focused the fines are on those insiders with power and information, the more likely it is that those fines will have the desired effect.

or untrue statements (s. 302). There are severe penalties—hefty fines or a lengthy prison term—if they do (s. 906). These sections provide a powerful deterrent against accounting manipulation'.

V. COMPARE AND CONTRAST OUR TWO-TIER EQUITY APPROACH WITH THE PRIOR PROPOSALS

1. Proposals (mostly by legal scholars) in Groups 1 and 2 above

a. Legal Mandate and Corporate Social Responsibility

Perhaps the most widely supported suggestion in these first two sets of proposals is to broaden the legal requirements to be applied to corporate boards and/or senior executives to incorporate certain social responsibilities. Whereas this might salve the conscience of the relevant regulators, we doubt that it would be effective, for several reasons. First, so long as management is paid in the same fashion, the bonus culture, it will remain in their self-interest to maximize short-term equity valuations; and the shareholders to whom management ultimately answer will also have the same incentive. Second it would be hard ever to prove in a court of law that those required to follow wider social objectives had ex ante consciously chosen not to do so. Thus it would be extremely difficult to enforce such obligations by ex post sanctions.

b. Confusion of Objectives

Next, it runs into the criticism so forcefully expressed by Milton Friedman in 1970 Milton Friedman in his seminal work in 1970, and partially repeated here, that such a measure would lead to an inappropriate confusion of political and business objectives.

Thus Schwarcz' proposals, for example, would still seem to run counter to Milton Friedman's arguments as set out in his New York Times Magazine article (13 September 1970) where he explains why in his view the social responsibility of corporate executives is to increase profits.[61]

2. Proposals (mostly by economists) in Group 3 above

a. Scale and perception

As far as we can see, almost all the economists' proposals on remuneration involve making a *proportion* of that deferrable and subject to clawback. A problem with this is that, even after such clawback, the senior managers would still be walking away with a total remuneration package, including their pension rights, which would still appear to most ordinary people to be ridiculously large (remember Fred Goodwin's pension payment which could not legally be cut back). By contrast, one could make the sanction in terms of the multiple liability for selected insiders to be as large as society might want.

61 <https://www.nytimes.com/1970/09/13/archives/article-15-no-title.html>What does it mean to say that the corporate executive has a 'social responsibility' in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire 'hardcore' unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.
In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his 'social responsibility' reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

The claim is frequently made that a failing in the capitalist system was that virtually no banker went to jail after the great financial crisis. But it is almost impossible, and wrong, to send people to jail for misreading, whether wilfully or not, the riskiness of a particular strategy (we do not think that Ed Kane (note 25, 2018a). could, or would, fly). On the other hand, it is perfectly possible to devise a set of economic sanctions so that the penalty on bankers in severe loss or default situations does become much more extreme than is possible or available under economists' schemes for deferred pay subject to clawback. Exactly how severe the penalty for corporate failure should be to fall on those responsible for the relevant decisions is an issue that we do not feel capable of deciding ourselves; it is a matter of wider social and political concern. But the economists' approach would limit the sanction to a proportion of pay, whereas the two-tier equity approach would enable society, should it so want, to impose whatever sanction it thought most appropriate. If it were the case that, even with clawback on deferred pay running at a much greater extent than at present, society still felt that the present structure of capitalism was unfair and unjust, then our proposal would have a significant benefit over these economists' proposals.

b. And what about the market for corporate control?

Almost all the economists' papers noted earlier make the implicit assumption that the current management remains in place and impregnable even after the change in compensation, as proposed, goes through. But there is a market in corporate control. If we assume that perceptions of opportunities are common both to managers and shareholders, and that the market for corporate control is frictionless, then if managers start behaving in a more risk-averse manner because of their new remuneration packages outside shareholders, such as activist hedge managers, will simply replace the existing management with managers who can be pressurized to behave as if their interests were again totally aligned with those of the limited liability shareholders. Indeed, there is a kind of Modigliani/Miller approach whereby shareholders can undo any incentive shifts that the economists' approach suggests. Of course information is asymmetric, and the takeover market is full of frictions, but, nevertheless, if the economists' proposals should change managerial behaviour significantly, this would lead to a much increased incentive for activist shareholders to enter the market for corporate control and return the incentive structure, by one means or another, to that which benefited themselves. A crucial difference between our proposal and that of the economists, is that we would include activist shareholders, once they had amassed a significant proportion of shares, among the set of insiders to whom the multiple liability would also apply.

c. High-trigger CoCos?

While we generally like the idea advanced by Calomiris and Herring of high-trigger CoCos, we do see some practical problems. First, much, perhaps most, of the variation in equity prices is caused by general economic cyclical fluctuations, rather than by idiosyncratic risk gambles. If the market should suddenly weaken, it would be disruptive in the extreme to have masses of corporates facing such triggers simultaneously because of fundamental macroeconomic problems. Moreover, the existence of such triggers could cause more volatility in equity prices, as existing shareholders try to bail-out, as the prospect of the trigger being activated became nearer. That could, perhaps in principle, be rectified, if the CoCo trigger was related to the market price of the equity of that particular corporation *relative* to some benchmark, rather than its absolute level. But what benchmark should one pick? And, as far as we are aware, no CoCo has been issued relative to a benchmark rather than to an absolute level; so this idea of a relative CoCo would itself be a novel and untried idea. Furthermore, there are a series of other practical problems relating to possible market manipulation, which would only be partly resolved by having the trigger relate to a moving average of equity market prices, rather than to the absolute price on any particular day (see Calomiris and Herring's proposal for a 'smoothed QMVER trigger'[62]).

3. Summary

We doubt whether the proposals for changing the objectives of limited liability corporations would be effective, so long as the structure of remuneration remains unchanged.

As for the economists' proposals, for example for clawback of deferred pay, some of the same issues are involved as arise with our proposal for a two-tier equity approach, in particular border problems. To whom would the clawback, or insider proposals, be applied? In general, our proposal would cover a somewhat wider circle of those with power and influence over corporate decisions, including activist holders of large blocks of shares and auditors, whereas the clawback proposals would probably be limited to the remuneration of the CEO and a handful, at most, of other senior executive directors.

More generally, these economists' proposals are incremental, relating only to a proportion of the pay of a small number of senior managers. Even if they did have a significant effect on managerial incentives and risk tolerance, they might well be undone in the market for corporate control, where the shareholders would still have an incentive to restructure managerial remuneration and other conditions in order to encourage managers to take on additional risk. Thus, we think that such proposals, although much more likely to be adopted since they are incremental, would not have a major effect on the conduct of—or the perception of—capitalism. And while we like the Calomiris/Herring proposal in principle, we think that the implications for equity markets could be adverse, unless the proposal was adjusted into a benchmark mechanism, which is yet to be even fully considered. In contrast, our proposals are both more complex and far reaching, but capable of inducing major changes to the structure and perception of capitalism, if that was what a democratic society wanted. It would represent a much more radical change, but, hence, by the same token it is probably much less likely to be adopted.

VI. CONCLUSIONS

There are many classes of debt, with various degrees of seniority. The purpose of this article is to suggest that, similarly, there should be two classes of equity. The division should be between outsiders with no inside knowledge of the working of

62 Calomiris and Herring (n 33) 52.

the firm and/or no ability to control its decisions, and insiders who have both the information and capacity to influence corporate decision-making. On the upside, when the bank/company is profitable, the interests of the insiders and outsiders would remain exactly aligned with each other, as at present. But limited liability applied generally leads to moral hazard and an excessive tendency to take risks, since bad outcomes can lead to costs being shifted to blameless outsiders and other stakeholders. The purpose of this proposal would be to shift the costs of failure back towards those who have the responsibility for taking these decisions. Whether, or not, failure is due to consciously excessive risk-taking, or other moral failings, failure will have serious costs and consequences. These need to be shared more fairly amongst those responsible for such decisions, alongside other stakeholders who will be adversely affected by such outcomes.

A further concluding observation relates to the potential interaction between extended liability for managers/insiders and regulation. The more that managers/insiders are required to take on additional liability, the less intrusive and extensive the regulation would need to be, given the internalization of costs that such extended liability would entail. Also note that higher required capital of itself acts to reduce RoE, whereas a higher contingent liability for 'insiders' does not do so. Hence a regulatory regime relying more on the latter could lead to a more vibrant banking system. In particular, firms like C Hoare & Co, who voluntarily choose to adopt unlimited liability should have the intensity of supervision and regulation greatly lessened.

There are two main alternative brands of reform which have been advanced to try to counter the shortcomings of the present capitalist system. The first of these is to seek to change the objectives of corporates, for example by introducing some type of public governance duty that requires managers to consider the wider social consequences of their firm's actions. We feel that this would not be effective in practice, primarily because it would leave managerial pecuniary incentives unchanged. The second set of proposals would seek to change managerial pecuniary incentives directly by exposing a proportion of their pay to clawback in the event of loss or failure. We think that this would also be largely ineffective because it would only relate to a proportion of pay and would, almost certainly, be limited in scope and scale. Even if it should appear to become effective, it could be largely undone in the market for corporate governance.

In contrast, our proposal would be more complex, certainly more wide ranging, and could be imposed at whatever level of scale and scope society might want. It would be considerably more radical than the above sets of proposals, but if our democratic society should feel the need for a radical change in the structure of capitalism, but one that would nevertheless leave the interests of shareholders and managers aligned on the upside, then this would be the way to go.

APPENDIX: HISTORICAL EXAMPLES OF MULTIPLE LIABILITY

A.1. The US historical record on limited liability and the experience of double liability

The first modern limited liability law was enacted by the State of New York in 1811 for manufacturing companies.[63] New Hampshire followed in 1816, and Connecticut in 1818.

The US Congress, through the passage of the National Banking Act of 1863, established double liability for national banks, providing that 'each shareholder shall be liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares'.[64] Double liability meant that shareholders could be assessed for an additional amount equal to the paid-in capital of the bank if the bank were to be placed into receivership. Thus, the actual amount of equity that acted as a buffer against losses from the depositors' perspective was more than the amount of paid-in capital and accumulated retained earnings.

'Following the implementation of the federal double liability system, States continued to adopt similar programs for their state-chartered banks and they implemented double liability rules for bank shareholders . . . Most of these state provisions were closely modeled on the National Bank Act . . . .'[65] The federal structure of US Government led to a system of decentralized corporate law with single limited liability laws co-existing with double liability laws for banks in the nineteenth and early twentieth century. As stated above, under double liability, bank shareholders were liable not only for the value of their investments, but also for the portion of a bank's debt in the case of insolvency.[66]

Single shareholder liability was adopted by banks in more rapidly growing States. States with more highly developed economies and banking systems, which had more to lose from banking instability, and States with a history of financial instability tended to adopt double liability in order to encourage more circumspect banking practices.[67] It has been argued that 'since risk-prone agricultural states were more likely to adopt double liability, and that since agricultural crises during the period were a principal cause of bank failures, in years

63 See Kevin Forbes, 'Limited Liability and the Development of the Business Corporation' (1986) 2(1) Journal of Law, Economics, and Organization 163, fn 4 <https://www.jstor.org/stable/764920?seq=1#page_scan_tab_contents>.

64 National Banking Act of 1863, ch 58, 12 Stat 665. Nowadays, however, par value has become meaningless. An alternative, for which we thank Sandra Boss, might be book value per diluted share at prior point of viability.

65 See Jonathan Macey and Geoffrey Miller, 'Double Liability of Bank Shareholders: History and Implications' (1992) 27 Wake Forest Law Review 31, 37.

66 Ibid 33: 'Double liability transforms shareholders from investors seeking to advantage themselves at the expense of other investors who benefit themselves by the decreasing the riskiness of these firms'. See also Howard Bodenhorn, 'Double Liability at Early American Banks', NBER Working Paper No. 21494, August 2015, revised January 2017.

67 Richard Grossman, 'Fear and greed: The evolution of double liability in American banking, 1865–1930' (2007) 44 Explorations in Economic History 59, 61.

of severe agricultural distress, double liability states would appear more risky than single liability states'.[68] In any case, given the flight of capital from States with unlimited or double liability to States with limited liability, the latter acquired greater popularity.

The effect of the end of double liability was masked by the move by banks from making loans to holding government debt,[69] as well as by State anti-branching regulations and the regulatory systems' inability to cope with a growing and more integrated and complex economy.[70]

The 1920s saw an unusually high number of bank failures. There were thirty-five clusters of suspended banks (182 suspended banks in all) between 1921 and 1929, largely in rural states.[71] This may have been due to the over-expansion of agriculture arising from increased demand for produce in World War I. This was followed by an agricultural depression with consequential loan defaults. The 1926 banking panic in Florida and Georgia was, however, the result of a land boom in these States, and businesses linked to this including interstate roads, railways, and ports. For example, in Georgia the 1926 series of runs was so severe (70 banks were closed within three days) that newspaper reporting was restricted.[72]

While there is some evidence of a correlation between the use of double shareholder liability and fewer bank defaults it is not clear if there is a causation link and, if so, in what direction causation runs.[73] Moreover by the early 1920s in the US any relationship between

68 Ibid 64.

69 Eugene White, *Rethinking the Regulation of Banking: Choice or Incentives?* (December 2010), mimeo, Rutgers University.

70 Eugene White, *The Regulation and Reform of the American Banking System, 1900–1929* (Princeton University Press 1983).

71 Lee Davison and Carlos Ramírez, 'Local banking panics of the 1920s: Identification and determinants' (2014) 66 Journal of Monetary Economics 164.

72 Ibid.

73 Haelim, Daniel and Dong Beom show that in the years 1926–1932 double liability did not seem to reduce banks' risk-taking, as measured by capital and cash ratios. They ascribe this finding to a supposed decline in depositor monitoring of double liability banks. Haelim, Daniel and Dong Beom, 'Reducing moral hazard at the expense of market discipline: The effectiveness of double liability before and during the Great Depression', FDIC Center for Financial Research Paper No 2018–05, 22 October 2018.But retail depositors generally have neither the capacity nor, in most cases, the incentive to monitor their own banks, preferring to leave this to regulators or other specialized monitoring agencies. We doubt, but do not know, whether the State-chartered banks of New York and New Jersey, the base for the econometric test, had much in the way of large, wholesale deposits. As the authors note (at 5), earlier studies had found that double liability 'became less effective in the 1920s due to the broadening of stock ownership during the economic boom . . .'. This was the era of the divorce between ownership and control, also see Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932). Control was shifting to managers. At this juncture bank managers were, we believe, rarely given (double liability) stock options. Instead, we surmise that their cash salary would be positively related to the size and profitability of their bank, while the worst that could happen to them if their bank did badly would be to lose their job, that is, their remuneration function was akin to that of a limited liability shareholder. So, as control shifted from a small group of closely connected shareholders to managers, the incentive of the latter would be to take advantage of the reputed safety of double liability to reduce capital and cash ratios.

the two had dissolved and banks were very exposed to both agricultural price collapse and bank runs.

Bank failures multiplied between 1929 and 1933. As Macey and Miller note, these failures ultimately resulted in political pressure that led to the abandonment of double liability.[74] The creation of the Federal Deposit Insurance Corporation was seen by many as a better solution to bank runs than double liability. 'In 1933 Congress repealed double liability for newly issued national bank shares; and in 1935, it extinguished all double liability for national bank stock provided that a bank gave a six months notice of termination. Federal double liability was all but moribund after 1934'.[75]

There is some evidence that double liability did serve to stabilize the US financial system, but the costs, including legal costs, of pursuing thousands of small shareholders to draw extra money from them brought the whole system into disrepute when so many banks collapsed in the 1930s.[76] The use of double liability declined during the 1930s following the lack of depositor confidence in the banking system and the introduction of federal deposit insurance via the Banking Act of 1933.[77] The bankruptcies of many shareholders who had taken no part in the management of failed banks generated political pressure on States to repeal double liability laws. It appears that prior to the 1930s double liability shares had provided beneficial returns to shareholders but this positive position started to reverse in the 1930s. In the period 1930–34 there was a substantial reduction in shareholder recoveries, and lowering the minimum denomination of national bank stock broadened stockholder distribution at large banks in ways that lowered the monitoring premium that a stockholder could earn in a double-liability contract.[78]

There were of course other regulatory factors which influenced risk-taking at State level including capital and reserving requirements and branching restrictions in addition to introduction of deposit insurance and more effective banking supervision.[79] The

74 Macey and Miller (n 65) 37. 'As one author noted in 1936, the double liability effectively bankrupt[s] many innocent stockholders who have taken no part in the active management and control of the bank.'

75 Ibid 38.

76 Charles Calomiris has written about this. For a recent paper see Charles W Calomiris and SM Elliot, 'Who Owned Citibank? Familiarity Bias and Business Network Influences on Stock Purchases 1925–1929', NBER Working Paper 24431 (March 2018) 9 <http://www.nber.org/papers/w24431>. See also Charles W Calomiris and Berry Wilson, 'Bank Capital and Portfolio Management: The 1930s "Capital Crunch" and the Scramble to Shed Risk' (2004) 77(3) Journal of Business of the University of Chicago.

77 Grossman (n 67) 64.

78 Berry Wilson and Edward Kane, 'The Demise of Double Liability as an Optimal Contract for Large-Bank Stockholders', NBER Working Paper Series, WP 5848 (December 1996).

79 Grossman (n 67) 75.

dire economic situation in the Great Depression[80] led to a general distrust in equity investments.

Notwithstanding the problems in administering the double liability rule,[81] some scholars continue to argue that the basic premise of double liability created a system of incentives and shareholder monitoring for banks, which instilled sound banking practices and limited reckless risk-taking.[82]

A.2. UK experience of unlimited and limited liability

Unlimited liability was the norm in the UK until the 1850s. The advent of joint stock companies following the passage of the Joint Stock Companies Act of 1844 did not limit shareholder liability. Indeed, creditors of a joint stock company could enforce by execution not only against the assets of the company but also against the property of any shareholder. In 1853 a Royal Mercantile Laws Commission was established to study modifications to liability of partners. As part of its evidence gathering the Commission issued a questionnaire including questions related to banks, to which responses indicated a lower support for changing the liability laws in the case of banks.[83] The responses reflected 'three perceived characteristics of banks: the special nature of bank's creditors, the effects of unlimited liability on the risk of a bank run . . . and the influence of unlimited liability on the quality of a bank's capital and its shareholders'.[84] The Commission's Report on the Mercantile Laws and Amendments to the Law of Partnership was published in 1854.

The first Limited Liability Act for companies was enacted in 1855. The legislature appeared to be suspicious of banks (and insurance firms) and thus they were excluded.[85]

80 See 'The key to industrial capitalism: limited liability' *The Economist* (23 December 1991) <https://www.economist.com/finance-and-economics/1999/12/23/the-key-to-industrial-capitalism-limited-liability>: 'Shares were first issued in the sixteenth century, by Europe's new joint-stock companies, led by the Muscovy Company, set up in London in 1553 to trade with Russia. (Bonds, from the French government, made their debut in 1555.) Equity's popularity waxed and waned over the next 300 years or so, soaring with the South Sea and Mississippi bubbles, then slumping, after both burst in 1720. But share-owning was mainly a gamble for the wealthy few, though by the early nineteenth century in London, Amsterdam and New York trading had moved from the coffee houses into specialised exchanges.' In 1932, 'America's GDP was around 60% of its 1929 value, 25% of the workforce out of work, and the Dow wavering at about one-seventh of its pre-crash high'.

81 See Macey and Miller (n 65) 39–55 for an excellent analysis of these problems.

82 Ibid 32.

83 Matthew Willison, 'Were Banks Special? Contrasting Viewpoints in Mid-Nineteenth Century Britain', *Bank of England Staff Working Paper* No 755 (September 2018).

84 Ibid 8.

85 As quoted by Paddy Ireland, an early critic of limited liability, Edward William Cox, had written in 1856 that the law of partnership had been: . . . '[T]hat he who acts through an agent should be responsible for his agent's acts, and that he who shares the profits of an enterprise ought also to be subject to its losses; that there is a moral obligation, which it is the duty of the laws of a civilised nation to enforce, to pay debts, perform contracts and make reparation for wrongs. Limited liability is founded on the opposite principle

As Ricardo eloquently wrote, the distinctive feature of the banker begins when he uses the money of others; as long as he uses his own money he is only a capitalist.[86] As a result of the company law changes in 1855 there was a major rise in the number of limited liability companies to nearly 5000 firms in England, and to an expansion in equity finance.

Shareholders in banks and insurance companies gained statutory permission for limited liability in 1862. 'By the 1870s, there were still circa 70 English banks which were companies with unlimited shareholder liability and shares traded on stock markets. However, only seven English banks took advantage of the 1862 Act' which permitted limited liability.[87] The reason why so few banks chose limited liability had largely to do with confidence and the avoidance of bank runs. The well-established banks considered that by staying with the unlimited liability system they would inspire greater trust in their customers.[88] Both bank shareholders and depositors believed that unlimited liability made for a more stable banking system because the liability of shareholders was an effective constraint on risk shifting and excessive risk-taking.[89]

A great concern in the nineteenth century was the 'spectral nature' of the joint stock company. In particular there was an ever-present worry 'that incorporated banks might evaporate and disappear since they were not real people'.[90] However, the position against limited liability began to change after the collapse in 1878 of the City of Glasgow Bank.

a. *The Scottish Banking System and the collapse of the City of Glasgow Bank*

In the nineteenth century Scotland had its own distinct banking system, which was different from the rest of the UK. Scotland had a large number of joint-stock banks but only the three chartered banks (Bank of Scotland, Royal Bank of Scotland, and British Linen Company) had limited liability.[91]

and permits a man to avail himself of acts if advantageous to him, and not to be responsible for them if they should be disadvantageous; to speculate for profits without being liable for losses; to make contracts, incur debts, and commit wrongs, the law depriving the creditor, the contractor, and the injured of a remedy against the property or person of the wrongdoer, beyond the limit, however small, at which it may please him to determine his own liability'. *See Paddy Ireland, 'Limited liability, shareholder rights and the problem of corporate irresponsibility' (2008) 34(5) Cambridge Journal of Economics 837* <https://academic.oup.com/cje/article/34/5/837/1700679>.

86 This citation of Ricardo is made by Walter Bagehot, *Lombard Street* (1873) [reprint edition by Arno Press, New York, 1978 of the 1915 edn published by Smith, Elder & Co, London] 21.

87 John Turner, 'The development of English company law before 1900', Queen's University Centre for Economic History (QUCEH), Queen's University Belfast, Working Paper Series, No 2017–01, 41.

88 Ron Harris,'The Private Origins of the Private Company: Britain 1862–1907' (2013) 33(2) Oxford Journal of Legal Studies, 339, 355.

89 Turner (n 87) 124. See also Leland Hamilton Jenks, The Migration of British Capital to 1875 (London, Thomas Nelson and Sons, 1963)

90 David Westbrook, *Between Citizen and State: An Introduction to Corporation Law* (Paradigm Publishers 2007).

91 Lawrence White, *Free Banking in Britain: Theory, Experience and Debate, 1800–1845* (2nd edn, Institute of Economic Affairs 1996) 37.

There was a global recession through the 1870s and into the 1890s. Known as the 'long depression', it had swept from Eastern Europe and Germany to the UK and across the Atlantic where it brought to grief a group of the 'robber barons'. However, paradoxically, the origins of this global affliction may be found in the rapid growth of wheat production in the newly opened prairies under the Homestead Act 1862. US wheat production rose from 170,000 bushels each year in 1866 to 322,000 in 1873 at the start of the crisis.[92] In parallel, the price of wheat fell from $2.95 per bushel in 1866 to $1.78 in 1873.[93] Much of the wheat was shipped to Europe, where it undercut the price of grain from Eastern Europe and Russia resulting in economic destitution and was, in part, responsible for the start of waves of immigration to America through the rest of the century and beyond.

Against this background, the City of Glasgow Bank had expanded its lending overseas during the boom of the 1860s. It had invested in illiquid industrial assets and its portfolio was very concentrated. Other banks had reduced their lending to industry and moved their funds to the liquid London money market.[94]

Liquidity pressures had been building in the UK's banking system from early 1878 and this contraction may have been the issue which finally put paid to the City of Glasgow Bank.[95]

The failure of the City of Glasgow Bank was due to a mixture of unscrupulous directors and poor corporate governance. The directors lent the bank's money to themselves and their associates and were not able to repay what had been borrowed. Within professional circles in Scotland, the bank was 'viewed with suspicion and regarded as a risky institution . . . the City of Glasgow Bank was never highly esteemed outside the circle of its dupes and seems to have been a long-continued fraud'.[96] It can be argued that problems are likely when bank ownership and lending policies start to diverge.[97] This may necessitate either a change in corporate governance or much more stringent regulatory supervision or both.

The high concentration of the bank's lending is evident in that 'just four borrowers accounting for 75% of total loans at the time of collapse. These four were all local businesses deeply involved with Indian and Australasian trade: James Morton & Co., John Innes Wright

92 Robert Sobel, *Panic on Wall Street* (first published in 1968, TT Dutton 1988) 157.

93 Ibid 158.

94 Dieter Ziegler, 'The Banking Crisis of 1878: Some Remarks' (1992) XLV(1) Economic History Review 137, 143.

95 Michael Collins, 'The Banking Crisis of 1878' (1989) 42(4)The Economic History Review 504, 504–5.

96 David Evans, 'Major and Minor British Banking Crises since 1800' in John Turner (ed), *Banking in Crisis: The Rise and Fall of British Banking Stability, 1800 to the Present* (CUP 2014) 66, 86.

97 Henry Hansmann and Mariana Pargendler, 'The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption', Faculty Scholarship Series 4721, (2014) Yale Law Journal 977.

& Co., Smith Fleming & Co. and James Nicol Fleming.'[98] There were investments in land reclamation projects for port development in Bombay as well as lending to finance the acquisition of land companies in Australia and New Zealand and railways in the US.[99]

At the time of its collapse, the bank had liabilities of £12.4m and assets of only £7.2m and the shareholders were required to make up the difference. All the depositors were repaid and the other Scottish banks honoured all the fiat notes issued by the bank since some of the Scottish banks had note issue rights. By the time the assessment process was over, only 254 of the 1819 shareholders remained solvent. 'Nearly 2000 families suffered severe loss; many were ruined. In addition, another Scottish bank, the Caledonian, found itself a direct casualty of the unlimited liability rule.'[100] The shareholders were largely concentrated in Glasgow and Edinburgh and the effects on the small communities were seared into the memory of the Scottish 'central belt'.

The penury into which City of Glasgow Bank shareholders had been thrown elicited a considerable amount of public sympathy.

> A great majority of them, perhaps a thousand out of the twelve hundred and fifty, have been totally ruined by a catastrophe which they foresaw as little as they might have done an earthquake or a landslip. A large section of them are most respectable persons, in the decline of life, who have retired from trades or professions to live on their small realised properties, who cannot return to work again with any chance of success, and who have before them no prospect, except the poor-house or the grudging charities of relatives or friends. Hundreds have wives and children dependent on their incomes, and in all cases probably the ruin is that of households rather than of individuals.[101]

The extensive press reporting 'portrayed the shareholders as socially vulnerable and financially ruined investors, with small shareholdings. The public were reported as viewing the failure of the City of Glasgow Bank and the impact on its shareholders as a national tragedy.'[102] The evidence of the bank's directors' incompetence led to the *Glasgow Herald* describing the directors' 'shipwreck of a noble institution; they have recklessly divided the plunder among themselves and their friends; and they have inflicted misery and ruin on thousands of innocent sufferers'.[103] The Glasgow correspondent of the London Times wrote: "the parties chiefly concerned, and on whom the weight of the calamity will fall, are small merchants, divines and doctors of Medicine, none of whom can be classed among the

98 Button, Knott, Macmanus and Willison (note 11) 25.
99 Ibid.
100 Collins (note 94)
101 *The Spectator* (1878) Vol 511, issue 2627, 2 November, 1363.
102 Button, Knott, Macmanus and Willison (n 11).
103 Forbes Munro, 'The failure of the City of Glasgow Bank, 1878–82' in *Maritime Enterprise and Empire, 1823–1893* (Boydell & Brewer, Boydell Press 2003) 254.

wealthy and very many of whom had invested their savings of a lifetime.[104] *The Times* also reported that almost all the lawyers and accountants in Glasgow had kept clear of the bank; 'those best qualified to advise investors would have nothing to do with its shares' and it was the lesser well connected and knowledgeable who were caught as shareholders in the failed bank.[105] Six directors and the general manager went to prison for false accounting.[106]

The newspapers may however have overstated the destitution caused by the bank's failure and the call on shareholders. For example, on 5 November 1878 *The Times* described 'the destitution and bereavement which this unfortunate calamity would entail and the list of shareholders embraced a terrible proportion of cases where the loss could mean nothing but absolute and hopeless beggary' and *The Economist* of 27 December 1879 stated that 'hundreds and thousands of cases homes have been broken up, health and life destroyed, dismay and ruin spread over towns and parishes, sons and daughters left penniless'.[107] The newspapers, in effect, highlighted to their readers that without a rapid change to the shareholder liability law, they could face a similar fate the next time a bank failed.

The traumatic collapse of the City of Glasgow Bank (as one of the largest unlimited liability banks in the UK) in October 1878[108] shifted the mood against unlimited liability and led to the passage of the Companies Act of 1879.[109] This Act created the concept of reserve liability 'which meant that banks could have extended liability, but less than unlimited liability; for example, some banks had double liability (ie, for every £100 of capital shareholders had paid in, they were liable for another £100) and others had various multiples of paid-up capital'.[110] This reserve liability could be called up only in the event of a bank's failing, unlike uncalled capital which also could be called up at the discretion of directors. It is interesting to note that firms, including banks, had two forms of the uncalled capital in the nineteenth century: one that was the shareholders' extended liability (unlimited initially, a multiple of their shareholding later on) which would be drawn on

104 Leo Rosenblum, 'The Failure of the City of Glasgow Bank' (December 1933) 8(4) The Accounting Review 285, 290–91.

105 Ibid 290–91.

106 Button, Knott, Macmanus and Willison (note 11) 25.

107 Quoted in Thomas Lee, 'A helpless class of shareholder': Newspapers and the City of Glasgow Bank failure' (2012) 22(2) Accounting History Review 143, 143, <https://www.tandfonline.com/doi/full/10.1080/21552851.2012.681125?src=recsys> accessed 11 June 2018).

108 Collins (n 94).

109 John Turner, *Banking in Crisis: The Rise and Fall of British Banking Stability, 1800 to the Present* (CUP 2014). The Overend Gurney collapse in 1866, Guy Morton pointed out in correspondence, was of an institution which had got in a precarious situation as an unlimited partnership and was trying to bail itself out by raising new money (on a false prospectus).

110 As reported by John Turner, 'The last acre and sixpence: Views on bank liability regimes in nineteenth century Britain' (2009) 16(2) Financial History Review 111, Walter Bagehot was 'against unlimited liability', but 'did favour shareholders having double or triple liability'.

to cover losses in the event of failure, and another one, that could be called in at the discretion of a firm's directors. As Grossman and Iami recall: '[U]ncalled capital may have served an important role: the unlimited liability of partners would only be relevant in the case of a liquidation of the firm; uncalled capital could be called in under much less dire conditions'.[111] All banks quickly limited their liability after the passage of the 1879 Act, but reserve liability—under which a shareholder was liable for a bank's debt up to some multiple of its shareholding—remained a feature of British banking until the mid-1950s,[112] which meant that banks could have extended liability but less than unlimited liability.[113] Reserve liability was thus a capped or limited liability over and above paid-up capital owed by shareholders to the bank which could be called on to make good any deficit on the bank's liquidation.

The existence of unlimited liability may have restricted the size of banks since a large balance sheet increased the risk of large losses for shareholders and, consequently, discouraged investment in banking. Further, as was seen with the City of Glasgow Bank, the link between shareholders and managers had ceased (principal/agency problem). The development of limited liability banks in the 1880s 'removed these barriers to the emergence of larger banks, contributing to a wave of bank mergers in the late 19th and early 20th century'.[114] This was coupled with a requirement for mandatory independent audits.[115]

As the demise of the City of Glasgow Bank illustrated, unlimited liability for shareholders fell into disrepute because it failed to address the agency problem and thus punished the innocent without deterring or punishing the guilty. It is, however, an effective driver of behaviour in a partnership because here the agency problem either does not exist or is tightly controlled—in an unlimited partnership, the individuals who effectively direct the business are also among the principal individuals who will suffer in the event of failure. But once a business moves from being a true partnership to being a company where ownership and management are in separate hands, the effectiveness of unlimited liability as a deterrent is reduced and the scope for creating injustice and hardship increases.

111 Grossman and Imai (n 42) 137. Grossman and Imai write how under the Companies Act 1879 a bank could divide its uncalled capital into two components. One could be called upon the discretion of the directors. The other was the reserve liability, which could only be called up in the event a bank was wound up.

112 Turner (n 108) 132. n 82 (n 7).

113 Graeme Acheson, Charles Hickson and John Turner, 'Does Limited Liability Matter? Evidence from Nineteenth-Century British Banking' (2006) XIV International Economic History Congress, Helsinki, <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.508.7416&rep=rep1&type=pdf> accessed 7 June 2018.

114 Button, Knott, Macmanus and Willison (note 11) 30.

115 The Companies Act 1879 (42 & 43 Vict c 76). The Institute of Chartered Accountants in England and Wales was founded in 1880 with its members providing these independent audits.

The scope of our proposal of partial shareholder liability is limited to directors/managers.[116] We are aware that with an ordinary share structure, unlimited liability could exacerbate the serious 'agency' problem which already exists. In general shareholders' ability to control management's activities is quite limited, given the vast difference of knowledge between the two. The experience of the Lloyd's insurance market in the late 1980s and 1990s is a cautionary example: many unlimited liability Names were ruined, while their agents suffered no more than loss of income.

A.3. A brief assessment of the Canadian experience of shareholder double liability

'Double liability was an inherent part of the Canadian banking system almost right from its creation . . ..'[117] Under the double liability rule in Canada, in the case of bank failure, bank shareholders were responsible for twice the amount of their subscribed shares, that is, for the amount of their subscribed shares and for an additional amount not larger than the par value of their shares. 'Facing higher possible losses, bank shareholders are likely to become more risk averse under the double liability rule, as compared to the single liability assessment leading to lower risk-taking.'[118] Between 1868 and 1881 double liability assessments were successfully levied on the shareholders of two of the eight banks that failed; between 1883 and 1899 there were 'nine bank failures and double liability was enforced in four cases; and in the period 1905–1923, there were nine bank failures and double liability was collected in eight cases'. Across all these periods, the successful collection rate of the double liability averaged 59 per cent of the paid-up capital compared with 49 per cent in the US.[119]

Canadian shareholder double liability was phased out between 1934–1950. This led to an increase in bank leverage 'mainly due to their shift towards investment in liquid government securities'. The enhanced regulation and supervision of chartered banks 'created entry barriers for potential new competitors. That led to the development of oligopoly in the Canadian banking market'.[120] Michael Bordo describes this as a 'grand bargain whereby the

116 Unlimited liability in relation to banks presents a further challenge: that in the circumstances of a modern bank it is too powerful an incentive and that is why we propose a system of intermediate liability. The reality of modern banking is that since the affairs of a modern bank are too complex, there might be little incentive for a prudent person to assume the responsibilities of management at all if that entails strict liability for the consequences of failure. Liability may also be tempered by the traditional 'has acted honestly and reasonably and ought to be excused' power of exoneration for misfeasance liability. Thanks to Guy Morton for observations on this point.

117 Anna Grodecka and Antonis Kotidis, 'Double Liability in a Branch Banking System: Historical Evidence from Canada' Working Paper Series 316, Sveriges Riksbank (Central Bank of Sweden) (2016) 4.

118 Ibid 2.

119 Ibid 4.

120 Ibid 30.

chartered banks would provide financial stability in exchange for the Canadian government limiting entry to the industry.'[121]

A.4. Brief reference to other jurisdictions

Under Swiss law, most banks are organized as sociétés anonymes.[122] Swiss law has a very strict notion of sociétés anonymes (Aktiengeslleschaften). Article 680(1) of the Code of obligations states: 'A shareholder may not be required, even under the articles of association, to contribute more than the amount fixed for subscription of a share on issue'. Until relatively recently, there were Swiss private bankers, that is, natural persons exercising the banking business (generally restricted to investment services) in some form of partnership. Such bankers were liable with all their personal assets for any liability of the bank. There would also be limited partners (*commanditaire*) whose liability was limited to the amount of their *commandite*.

In civil law jurisdictions, the corporate form of the *société en comandite* in France or *Sociedad en comandita* (*Sociedad comanditaria*) in Spain or *Kommanditgesellschaft* in Germany permits limited partnership business entities in which partners with unlimited liability coexist with partners whose liability is limited to their fixed contributions to the partnership. These provide further examples of the possibility of establishing different categories of financial liability that coexist together under the same corporate structure.

Coming back to Switzerland, private bankers such as Pictet, Lombard Pictet Group, Bank Lombard Odier and Mirabaud Group Mirabaud, retained that legal structure for their Swiss operation until 2014, when they transformed it into sociétés anonyme. (All other entities in their group were already companies limited by shares.) They retain an element of partnership at the holding level, where they are protected by the limited liability of their many operational subsidiaries, including the flagship Swiss bank.[123]

The idea of financial liability 'with teeth' (intermediate liability) attached to senior bank managers provides an innovative solution that not only enhances individual accountability

121 Michael Bordo, Angela Redish and Hugh Rockoff, 'Why didn't Canada have a banking crisis in 2008 (or in 1930, or 1907, or . . .)?' NBER Working Paper No 17312 (2011) <http://www.nber.org/papers/w17312>.

122 A number of them distribute shares or share options to their directors and some top employees, or allow them to buy shares at a discounted price. However, these shares do not include some potential liability for these special shareholders. The way it is now done is a contract (and some form of escrow where necessary) which allows the company to claw back the shares (or cancel the options) in case of certain defined events happen. Thanks to Luc Thévenoz for information on points of Swiss law.

123 Thanks to Luc Thévenoz for information on points of Swiss law.

(correct bank incentives) but also contributes to financial stability, considered in the aftermath of the global financial crisis as a public good.[124]

Though the EC Twelfth Council Company Law Directive[125] of 1989 requires Member States to make available legal structures for individuals to trade with limited liability[126] the European Union provides an interesting example of the increasing differential corporate and regulatory treatment of banks as compared to other companies. Regulation has expanded exponentially in the banking sector over the last two decades in the European Union (and beyond). Furthermore, special resolution and State aid rules regarding banking point to the continuous specialty of banking and emphasize the need to design an adequate system of incentives that minimizes excessive bank risk-taking to the detriment of society.

124 There are of course a number of design issues which require further research. For example for liability to stick to the right person, it would require a prohibition to sell the shares for a given period of time. Perhaps the same result might be achieved by way of a contract with the manager to whom (ordinary) shares or options are issued. If we want the liability to be potentially greater than the value of the shares, a contract could also achieve that.

125 <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex:31989L0667>.

126 Implemented in England and Wales by The Companies (Single Member Private Limited Companies) Regulations 1992 SI 1992/1699 1992/1699.