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Unlimited Liability and Free Banking in Scotland: A Note

JACK CARR, SHERRY GLIED, AND FRANK MATHEWSON

In his book *Free Banking in Britain* Lawrence White examines the free banking period in Scotland in the eighteenth and nineteenth centuries.[1] White maintains that there was free banking in Scotland from 1716 to 1844: "entry was completely free and the right to note issue universal" (p. 23). While we do not argue with White's characterization of the Scottish experience as one of free banking, we believe that he gives inadequate weight to an important restriction on most Scottish banks. Open entry with note-issuing privileges was subordinated to the entrant's shareholders' acceptance of unlimited liability.[2] The institutional facts are these: three banks (Bank of Scotland, Royal Bank of Scotland, British Linen Company) enjoyed limited liability privileges through explicit charters granted by the Scottish Parliament; all others faced unlimited liability. In an earlier paper we argued that this situation restricted Scottish banks' ability to compete with the three privileged banks.[3] In this experimental period of market organization in banking in Scotland, competition was not as vigorous as might appear at first. In addition, under our hypothesis this episode of Scottish banking provides an example of the state's ability and willingness to dispense rents to economic agents at the apparent expense of efficient (narrowly defined) resource allocation.

What is the survival evidence? From 1695 to 1845 in Scotland, over 50 banks failed or left banking.[4] Over this same period the three limited liability banks, all located in Edinburgh, survived. The total number of Edinburgh banks fell from 21 in 1772 to 6 in 1850, including the three limited liability banks. This evidence lends support to the hypothesis that unlimited liability put banks at a disadvantage with regard to their limited liability competitors. Faced with a choice, depositors continued to support those banks with limited liability. Also, from 1800 onwards, the average size of the limited liability banks is almost ten times that of the unlimited banks. This evidence supports the hypothesis that the motivation for the unlimited liability requirement for all but three banks was to protect those three banks from effective competition of new entrants. We do not believe that the unlimited liability requirement was needed to protect depositors. Had it been, the unlimited liability banks would have expanded at the expense of the three limited liability banks. The evidence does not bear this out. Hence we support a private interest theory of this restriction rather than a public interest theory.

Why does White ignore the significance of the unlimited liability barrier? Part of the explanation seems to be a belief (one White shares with other writers) that unlimited

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[1] Lawrence White, *Free Banking in Britain: Theory, Experience and Debate, 1800–1845* (Cambridge, 1984).

[2] The free banking episode in the United States, which started with the Free Banking Law of New York State, was one where all bank shareholders had limited liability. For a discussion of limited liability in U.S. banks, see Richard Sylla, "Early American Banking: The Significance of the Corporate Form," *Business and Economic History*, second series, 14 (1985), pp. 105–23.

[3] Jack Carr and Frank Mathewson, "Unlimited Liability as a Barrier to Entry," *Journal of Political Economy*, 96 (Aug. 1988), pp. 766–84.

[4] In tables 2, 3, 9, 11, and 16, S. Checkland, *Scottish Banking: A History, 1695–1973* (Glasgow, 1975), records the historical characteristics of the Scottish banking industry.

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liability restrictions had no economic significance.[5] He relies on the evidence that when Scottish banks were given the freedom to adopt limited liability in 1862 they waited 20 years, until 1882, to exercise the option.[6] "Limited liability was not made available to the non-chartered banks until 1862 and was not adopted by them until (after much cajolery) 1882. Each bank feared that a loss of public confidence would follow its putting 'Limited' after its name" (p. 41). "All but three of Scotland's banks operated with unlimited liability during the free banking era, showing that unlimited liability is not impracticable. . . . So long as unlimited liability is not compulsory but firms may also be formed with limited liability for contractual obligations, there appears to be no obstacle in principle to the portfolio risks of banking being borne only by those most willing to bear them, be they note holders and deposit holders or shareholders, or some combination of these. *Recall that the unchartered banks of Scotland chose to retain unlimited liability in the 1860's and 1870's even after limited liability became available to them*" (pp. 142–43, emphasis added).

If White is correct that Scottish banks waited 20 years to adopt limited liability, unlimited liability restrictions were indeed nonbinding and White would correctly ignore them in his discussion of free banking in Scotland. We claim, however, that the facts do not support this position. We believe that White misinterprets the changes in legal liability rules for Scottish banks and so overestimates the vigor of competition in this period of Scottish banking.

THEORY OF LIMITED LIABILITY

Carr and Mathewson present a complete development of the economic theory characterizing the equilibrium features of markets with competition between limited and unlimited liability firms.[7] It is sufficient here to summarize the relevant economic issues. What are the benefits and costs for firms, in particular banks, of one liability rule over the other?

Under limited liability, shareholders know that the maximum liability that they face in the future is their initial investment in the firm. This is not the case with unlimited liability, where the personal wealth of shareholders may be used to settle debts of the firm: shareholders are jointly and severally liable. To avoid being liable for other shareholders' portions of the firm's debts under bankruptcy, each shareholder needs either to monitor the wealth levels of other current shareholders, a continuing activity as both wealth levels and shareholders' identities may change, or to include costly covenants in the ownership rights that restrict their transferability to individuals of sufficient wealth. In either case the cost of capital is higher under unlimited as opposed to limited liability—this is known as the secondary markets effect. As a consequence, the value of unlimited liability shares are reduced relative to their limited liability counterparts and unlimited liability is a more costly form of organization.[8]

[5] In contrast, Alexander Blair, *Some Observations Upon the Present State of Banking* (Edinburgh, 1841), believed in the efficiency of limited liability for banks.

[6] White may have been relying on Checkland for this evidence. "The Company Acts had made limited liability available to business enterprises generally. The banks in Scotland . . . had made no move to adopt it, preferring that the obligation should continue to rest on shareholders; they felt that such a step would reduce public confidence in them and so harm their business. Even after the debacle of 1878, the Scottish banks were still reluctant to limit liability to subscribed shares" (Checkland, *Scottish Banking*, p. 480).

[7] Carr and Mathewson, "Unlimited Liability as a Barrier to Entry."

[8] A similar observation was made by John Stuart Mill, "Testimony" in *Report from the Select Committee on Investment for the Savings of the Middle and Working Classes*, vol. 19 (London, 1951): "I think that the great value of a limitation of responsibility, as relates to the working classes, would be not so much to facilitate the investment of their savings, not so much to enable

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If unlimited liability did not reduce the transferability of shares and if depositors could obtain outside insurance contracts to guarantee rates of return, the liability rules would not matter. The insurance market, however, can not write better contracts than the banks because of moral-hazard considerations: such contracts would reduce the incentives for depositors to shop for superior deposit contracts and for banks to compete with each other. In general, our results are an application of the Coase theorem: in the presence of secondary-market and transactional effects, which are distorting at the margin, the allocation of liability is relevant for resource efficiency.

LIABILITY RULES AND SCOTTISH BANKING

From 1716 to 1844 Scottish banking was characterized by free entry and unlimited note issue; only three banks, however, were permitted the privilege of limited liability; all the other Scottish banks operated under an unlimited liability regime. The Peel Bank Act of 1844 prohibited new entry into the note-issuing industry in all parts of the United Kingdom. The Scottish Bank Act of 1845 froze the note issue of existing Scottish banks to its average circulation during a specified past period. This quota could be exceeded only if banks held 100 percent reserves (in specie) on the excess note issue. The Bank Acts of 1844 and 1845 essentially cartelized the Scottish banking industry. They prohibited new entry and competition (as far as note issue was concerned) among the existing banks.

These provisions, however, did leave intact the unlimited liability restrictions. The Companies Act of 1862 allowed for a change in liability rules for all banks in the United Kingdom, but the change was not a simple movement to limited liability, as White seems to believe. Section 182 of the 1862 Act is the relevant section and states:

> No Banking Company claiming to issue Note in the United Kingdom shall be entitled to limited liability in respect of such Issue, but shall continue subject to Unlimited Liability in respect thereof, and, if necessary, the Assets shall be marshalled for the Benefit of the general Creditors, and the Members shall be liable for the whole Amount of the Issue, in addition to the Sum for which they would be liable as Members of a Limited Company.

This means that the 1862 Act allowed limited liability for all bank liabilities *except* for note-issue liability. Furthermore, general creditors were ranked *ahead* of note holders. If a bank failed, its assets would be used first to pay off general creditors (depositors and so forth). If these assets were insufficient to pay off the general creditors, then the shareholders of banks adopting limited liability would not be liable for any unpaid debts owing to the general creditors. The shareholders, however, would still retain unlimited liability on the note issue of the bank. To summarize, the 1862 Act continued to maintain unlimited liability for a significant share of the liabilities of Scottish banks. It is hardly surprising, therefore, that no Scottish bank adopted the restricted limited liability privileges of the 1862 Act. In believing that the 1862 Act offered to all nonchartered banks limited liability privileges similar to those explicitly in the charters of the three Edinburgh banks, White (as well as Checkland) misinterprets the provisions of this 1862 Act. The Act did *not* allow Scottish banks to adopt limited liability for all classes of liability. Only the three Edinburgh banks continued to enjoy universal limited liability privileges. Only in 1879 were the effects of unlimited liability substantially lessened for note issue. Section 6 of the 1879 Act replaced section 182 of the Act of 1862. Section 6 of the new Act states:

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the poor to lend to those who are rich, as to enable the rich to lend to those who are poor." More recently, Susan Woodward, "Limited Liability in the Theory of the Firm," *Journal of Institutional and Theoretical Economics*, 141 (Dec. 1985), pp. 601–11, has examined the transactions motive for limited liability.

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TABLE 1
SHAREHOLDER LIABILITY UNDER DIFFERENT LIABILITY REGIMES

Regime	Other Liability Holders Receive	Note Holders Receive	Additional Contribution of Shareholders
Unlimited Liability Regime, 1695–1862	65	10	25
1862 Company Act	50	10	10
1879 Company Act	40	10	0

Source: See text.

Section one hundred and eight-two of the Companies Act 1862, is hereby repealed, and in place thereof it is enacted as follows: A bank of issue registered as a limited company, either before or after the passing of this Act, shall not be entitled to limited liability in respect of its notes; and the members thereof shall continue liable in respect of its notes in the same manner as if it had been registered as an unlimited company: but in case the general assets of the company are, in the event of the company being wound up, insufficient to satisfy the claims of both the noteholders and the general creditors, then the members, after satisfying the remaining demands of the noteholders, shall be liable to contribute towards payment of the debts of the general creditors a sum equal to the amount received by the noteholders out of the general assets of the company.

For the purposes of this section the expression "the general assets of the company" means the funds available for payment of the general creditor as well as the noteholder.

It shall be lawful for any bank of issue registered as a limited company to make a statement on its notes to the effect that the limited liability does not extend to its notes, and that the members of the company continue liable in respect of its notes in the same manner as if it had been registered as an unlimited company.

In effect, this section still retained unlimited liability for note issue, but now note holders ranked ahead of general creditors. If a Scottish bank was wound up, the claims of note holders were satisfied first and then the claims of all other creditors were considered. General creditors were guaranteed a sum equal to that received by the note holders. In 1865 note issue represented 6.6 percent of total liabilities (including capital) of Scottish banks; by 1882 note issue had fallen to 5.5 percent of total liabilities.[9] According to section 6 of the 1879 Act then, as long as assets equaled at least 11 percent of total liabilities, shareholders would not be required to provide additional funds if a bank failed. This meant there was little likelihood that additional stockholder wealth would be at risk in the case of bankruptcy.

A numerical example serves to illustrate the impact on the residual liability of shareholders of Scottish banks under the general provisions of each of the Acts. Table 1 records shareholder liability in the case of bank failure under the provisions of the different liability regimes that prevailed in Scotland. In each case market value of assets is 50 whereas total liabilities plus shareholder equity is 100 (note liability is 10 and other liability is 65). Shareholder liability is greatest under the unlimited liability regime that prevailed until 1862. With the 1862 changes, shareholder liability is reduced but *not eliminated* in case of failure. With the 1879 changes and with note issue representing a small fraction of total liabilities, additional shareholder liability is eliminated for a large fraction of bank failures.

With the 1879 changes, limited liability was now feasible for the first time for all Scottish banks. In 1882 the seven surviving unlimited liability Scottish banks adopted

[9] See Rondo Cameron, *Banking in the Early Stages of Industrialization* (New York, 1967), p. 66, table III.1.

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the provisions of the 1879 Act. Faced with the choice between de facto limited and unlimited liability, all Scottish banks chose limited liability.

CONCLUSIONS

The alleged failure of Scottish banks to adopt limited liability in 1862 is used to support the contention that unlimited liability was not an impediment to vigorous competition in the industry. This belief is incorrect. The limited liability offered in 1862 did not extend to note issue. De facto limited liability became available for Scottish banks only in 1879. The evidence indicates that Scottish banks adopted limited liability soon after it became available, lending support to the hypothesis that restrictive liability rules in existence from 1716 to 1879 were economically significant. This is consistent with the larger view that regulatory intervention by the state is motivated by considerations of redistributional objectives consistent with political survival. We argue that changes in liability rules applied to banking in Scotland coincident with explicit restrictions on entry can be explained as a rational state response to the growing efficiency of branch banking and the need for assembling larger amounts of capital to facilitate larger and more efficient banking corporations. These developments increased the cost of using unlimited liability restrictions to protect the three banks and resulted in the adoption of less costly measures (that is, more efficient measures which did not artificially restrict firm size) to protect the banks. These less costly measures were the explicit entry restrictions of the 1844 and 1845 Acts. In considering the period of Scottish free banking from 1716 to 1844, these restrictions of unlimited liability should be interpreted as a significant impediment to the freedom of competition in free banking in Scotland.

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