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Much ado about nothing: the limitation of liability and the market for 19th century Irish bank stock☆

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Abstract

Limited liability is widely believed to be a prerequisite for the emergence of an active and liquid securities market because the transactions costs associated with trading ownership of unlimited liability firms are viewed as prohibitive. In this article, we examine the trading of shares in an Irish bank, which limited its liability in 1883. Using this bank's archives, we assemble a time series of trading data, which we test for structural breaks. Our results suggest that the move to limited liability had a negligible impact upon the trading of this bank's shares.

Keywords: Limited liability; Unlimited liability; Securities market; Bank; Ireland

1. Introduction

Limited liability is believed to be the sine qua non of the corporation; concomitantly, unlimited liability is believed to be anachronistic. Thus, the standard view is that firms

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carrying unlimited shareholder liability are less efficient than limited liability ones (see Henry Hansmann and Reiner Kraakman (2000, pp. 423–427) and Kraakman (1998, p. 649)). According to this standard view, one aspect of this inefficiency is the relatively high costs associated with trading the shares of a joint and several unlimited liability firm (Easterbrook and Fischel, 1985; Forbes, 1986; Halpern et al., 1980; Hansmann and Kraakman, 1991; Hansmann and Kraakman, 2000; Kraakman, 1998; Winton, 1993; Woodward, 1985). Indeed, Halpern et al. (1980) infer that limited liability is a necessary precondition for the existence of an organized and liquid securities market.

In the light of the above perceived inefficiency, it is somewhat remarkable that in Britain and Ireland the privilege of limited liability was not generally available to all firms until 1855. Previously, limited liability was regarded by the State as a privilege to be granted only to firms that it recognised as performing a public service. Paradoxically, prior to 1855, joint and several unlimited liability corporations were commonplace, as Parliament, from the early 19th century onwards, was increasingly liberal in conferring corporate status upon businesses. This facilitated the development of a viable market for company shares, such that by 1843, there were 720 joint-stock companies trading on the London market alone (Harris, 2000, p. 222). Notably, a large number of these firms were banks, which in the mid-1820s became the first business sector freely allowed to incorporate without prior Parliamentary approval.[1]

The Irish joint-stock banks founded following the liberalization of banking incorporation were predominantly large institutions characterized by substantial branch networks and large numbers of shareholders. Indeed, they were amongst the largest companies with tradable shares in 19th century Ireland. Unlike many other Irish industries, banking had over 50 years of experience with a joint and several unlimited liability regime, and only converted to limited but extended liability in the early 1880s.

This paper examines the impact of shareholder liability regimes upon the market for the shares of an Irish bank over a 57-year period. Notably, for the first forty-seven years of this period and up until late 1883, the shares of this bank carried joint and several unlimited liability, after which their liability was limited to four times their paid-up capital on a pro rata basis. From the bank's business archives, we were able to obtain data on every share trade which took place between 1837 and 1893. According to the standard view, the limitation of liability should result in greater liquidity in the market for bank shares. Consequently, one should observe dramatic increases in trading activity after the conversion to limited liability. However, we find that, despite a 50% increase in share capital and a trebling of shareholder numbers, the limitation of liability was much ado about nothing from a trading perspective. We suggest that vetting of new investors by directors greatly reduced the costs of trading securities carrying unlimited liability, resulting in the limitation of liability having little impact on liquidity.

The next section of the paper examines the evolution of shareholder liability regimes in Irish banking. The third section explores the relationship between shareholder liability and the liquidity of securities markets. In the penultimate section, we

[1] Irish Banking Copartnership Regulation Act (6 Geo. IV, c.42) and Banking Copartnership Act (7 Geo. IV, c.46).