Loyola University Chicago Law Journal

Volume 50
Issue 3 *Spring 2019*

Article 4

2019

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Recommended Citation

Steven A. Ramirez, *Lehman 10 Years Later: Lessons Learned?*, 50 Loy. U. Chi. L. J. 512 ().
Available at: https://lawecommons.luc.edu/luclj/vol50/iss3/4

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Lehman 10 Years Later: Lessons Learned?

Few events cast a greater shadow on our times than the Great Financial Crisis of 2008 that followed the failure of Lehman Brothers on September 15, 2008.[1] The Federal Reserve Bank of San Francisco recently published research estimating total costs to the American economy of $70,000 per US resident—and counting.[2] The crisis reverberated across the developed world, with some nations suffering much greater economic damage than the US.[3] In addition to the many trillions of dollars in lost output, the crisis created a polarized political environment giving rise to populist movements of dubious impact across the world.[4] The fact that the government allowed every banker at every bailed-out megabank to escape with virtually zero accountability certainly raises questions about the rule of law in America generally and the financial sector in particular.[5] Congress passed the Dodd-Frank Act of 2010,[6] a historic effort to regulate big finance, in response to these historic realities.[7] Certainly, the

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1. Anne Sraders, *The Lehman Brothers Collapse and How It's Changed the Economy Today*, THESTREET (Sept. 12, 2018, 4:52 PM), https://www.thestreet.com/markets/bankruptcy/lehman-brothers-collapse-14703153 ("In one of the most massive bankruptcies in United States history, the Lehman Brothers collapse marks its 10-year anniversary in September 2018. The firm's demise is nearly synonymous with the 2008 financial crisis, and the economy is still feeling the repercussions of its destruction.").

2. REGIS BARNICHON ET AL., FRBST ECONOMIC LETTER:THE FINANCIAL CRISIS AT 10: WILL WE EVER RECOVER? 1 (2018), https://www.frbsf.org/economic-research/files/el2018-19.pdf (finding that "the U.S. economy remains significantly smaller than it should be based on its pre-crisis growth trend" and that "[t]he size of those losses suggests that the level of output is unlikely to revert to its pre-crisis trend level. This represents a lifetime present-value income loss of about $70,000 for every American").

3. Patrice Ollivaud & David Turner, *The Effect of the Global Financial Crisis on OECD Potential Output*, 2014 OECD J.: ECON. STUD. 41, 48–49 (showing output gap in US at 3.3 percent; Italy 6.0 percent; and, Greece 12.9 percent).

4. Gautam Mukunda, *The Social and Political Costs of the Financial Crisis, 10 Years Later*, HARV. BUS. REV. (Sept. 25, 2018), https://hbr.org/2018/09/the-social-and-political-costs-of-the-financial-crisis-10-years-later ("But the most important effects of the financial crisis may be political and social, not economic. The years after the crisis saw sharp increases in political polarization and the rise of populist movements on both the left and right in Europe and the U.S. . . . .").

5. *See* MARY KREINER RAMIREZ & STEVEN A. RAMIREZ, THE CASE FOR THE CORPORATE DEATH PENALTY xi–xiv (2017).

6. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

7. Mayra Rodriguez Valladares, *It's High Time to Stop the Dodd-Frank Blame Game*, FORBES (Aug. 15, 2018, 7:32 AM), https://www.forbes.com/sites/mayrarodriguezvalladares/2018/08/15/high-time-to-stop-the-dodd-frank-blame-game/#53e55ec865d2 (terming Dodd-Frank a landmark legislative effort).

crisis imposed a new economic and political reality upon humanity as well as the financial sector.

By early 2019, however, the US economy set records for macroeconomic performance. Unemployment fell to a 50 year low in April 2019,[8] on the heels of a record 103 straight months of job growth.[9] Now, stock market indices routinely close at record highs.[10] The economic expansion following the financial crisis appears destined to become the longest on record.[11] In fact, bank lending and credit hovers at an all-time high.[12] All of these signs of economic strength even raised questions regarding the emergence of new debt bubbles similar to the subprime bubble of pre-2008.[13] In short, the brutal bust of 2008 gave way to an epic boom ten years later.[14]

These facts all raise compelling questions of legal and regulatory policy. Does financial instability still pose a threat to our economy ten years after the failure of Lehman caused an economic tailspin? Do financial elites now face sufficient legal and regulatory accountability? Does the Dodd-Frank Act need any adjustment? Do regulators now hold sufficient power to avoid a repeat of 2008–2009?

All of these questions and more form the subject matter of this symposium issue of the *Loyola University Chicago Law Journal*. The articles and essays herein arise from the *Lehman 10 Years Later: Lessons Learned?* conference hosted by the Institute for Investor Protection at the School of Law on September 14, 2018. The symposium and the conference certainly do not answer every outstanding question from the Great Financial Crisis of 2008. Nevertheless, the articles and essays from this issue of the *Law Journal* shed light on many of the key issues

8. Eric Morath & Sarah Chaney, *Jobless Rate Falls to Lowest in Nearly 50 Years as Employers Ramp Up Hiring*, WALL ST. J. (May 3, 2019, 5:51 PM), https://www.wsj.com/articles/u-s-hiring-jumps-in-april-unemployment-falls-to-3-6-11556886731.

9. Heather Long, *Is this Economy too Good to Be True?*, WASH. POST (May 3, 2019), https://www.washingtonpost.com/business/economy/is-this-the-too-good-to-be-true-economy/2019/05/03/9f05aff0-6dbc-11e9-8f44-e8d8bb1df986_story.html?utm_term=.a45b63cf6948.

10. Scott Lehtonen, *Is This a Major New Bull Market? The Dow Jones Industrial Average Says Yes*, INV. BUS. DAILY (May 3, 2019), https://www.investors.com/news/stock-market-outlook-2019-new-bull-market/.

11. Jeffry Bartash, *Stars Are Aligned for Economy as It Closes in on Record for Longest Expansion*, MARKETWATCH (May 7, 2019, 8:49 AM), https://www.marketwatch.com/story/stars-are-aligned-for-economy-as-it-closes-in-on-record-for-longest-expansion-2019-05-04.

12. Valladares, *supra* note 7 (showing record high levels of consumer loans and corporate debt).

13. Randall W. Forsyth, *Corporate Credit Could Be the Next Bubble to Burst*, BARRON'S (Feb. 15, 2019, 1:31 PM), https://www.barrons.com/articles/debt-be-not-proud-danger-in-the-complacency-about-corporate-credit-51550248974.

14. Not all Americans share in the boom as the threat of high economic inequality continues to linger with most Americans facing economic stagnation for forty years and counting. *See* Thomas Piketty et al., *Distributional National Accounts: Methods and Estimates for the United States*, 133 Q. J. ECON. 553, 557 (2018).

surrounding the crisis and its aftermath.

For example, former Representative and Chair of the House Financial Services Committee Barney Frank provides a broad overview of the underlying causes of the crisis and the remedies imposed under the Dodd-Frank Act to prevent a recurrence of the crisis.[15] Frank's account brilliantly explains the major causes of the crisis and the logic underlying the Act's responses in his remarks that are remarkable for their brevity.[16] For critics arguing that the Act went too far, such as President Trump, he replies:

> It really is not logically possible to insist that we have the best economy in the history of the world, humming along at full productive weight, but that somehow the liberals crippled the mechanism by which it functions. The fact is, what we did has had very little negative effect on the economy, has increased stability.[17]

For those on the left, arguing that Dodd-Frank did not go far enough, the Former Congressman states:

> There are very few derivatives these days of the kind AIG engaged in where the counterparties, as they are called, don't have enough money between them. Derivatives these days are much more carefully monitored, and they are exchanged under derivatives. The bad loans are not being made anymore.[18]

Without the derivatives abuses at AIG and the toxic mortgages originated at places like Countrywide, it is difficult to imagine the crisis exploding the financial sector like what occurred in 2008–2009.[19] The high levels of financial stability and the relative high level of macroeconomic performance since the enactment of Dodd-Frank suggests that it may well stand as an example of getting regulation right.

Former Northern Trust Chief Risk Officer Jeff Cohodes echoes this point. From his c-suite perch at a Systemically Important Financial Institution, Cohodes lived through the implementation of Dodd-Frank, and gives the Act somewhat surprisingly high grades, coming from the perspective of the regulated.[20] He notes:

> However, culture is a difficult animal to regulate. It is what results in either prudent or excessive risk taking. It is what permits or discourages risk taking, beyond corporate appetite or for personal enrichment. A strong risk culture results in recognizing risk issues,

15. Barney Frank, *What We Did Last ~~Summer~~ Crisis*, 50 LOY. U. CHI. L.J. 523 (2019).
16. *Id.*
17. *Id.* at 532.
18. *Id.* at 531.
19. *See, e.g.*, RAMIREZ & RAMIREZ, *supra* note 5, at 59–86, 133–55 (devoting two chapters to the role of misconduct at Countrywide and AIG).
20. Jeff Cohodes, *Perspectives on Dodd-Frank Act, Risk Management, and the Financial Crisis of 2008 from a Former Chief Risk Officer*, 50 LOY. U. CHI. L.J. 533 (2019).

> assessing risk, escalating issues, and timely remediation. It drives accountability, tone from the top, open challenge, compensation paradigms, teamwork, and succession.[21]

These caveats suggest that given enough time, risk failures will reappear, in favor of higher short-term profits to drive compensation and bonus payments, as occurred in the Great Financial Crisis. A "strong risk culture" cannot be instilled by regulations and thus may require more legal support from alternative mechanisms of accountability.

Professor Marc Steinberg addresses one such alternative mechanism beyond bank regulation—corporate governance. Steinberg traces the evolution of federal efforts to improve or even displace state law-based corporate governance going back to the turn of the twentieth century.[22] He concludes:

> The federalization of corporate governance is an evolutionary process that . . . . has gone through periods of gradual transition, activism, and stagnation. Certainly, the Sarbanes-Oxley and Dodd-Frank Acts have intensified this process. Today, to the greatest extent in our nation's history, federal law plays a central role in the governance of publicly held corporations. Undoubtedly, this federalization process will serve as a primary determiner for the continuing stability of the US securities markets and the quest for meaningful investor protection.[23]

Steinberg, like Cohodes, hints at a problem that lies beyond mere statutory law: he argues that the SEC failed "abysmally" to use the power Congress gave to the Commission to impose accountability upon "control persons" such as CEOs and other c-suite executives.[24]

Professor Thomas Joo raises serious questions regarding the recent Dodd-Frank rollback.[25] Congress recently acted to free banks of many of the new Dodd-Frank rules based upon the size of the bank.[26] Specifically, he suggests that "the cost savings for banks may be outweighed by increased risks to the institutions, their customers, or the financial system generally."[27] Joo suggests that now, during a time of economic expansion and higher profitably, is hardly the time to deregulate in the name of even higher profits:

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21. *Id.* at 537.
22. Marc I. Steinberg, *The Federalization of Corporate Governance—An Evolving Process*, 50 LOY. U. CHI. L.J. 539 (2019).
23. *Id.* at 560.
24. *Id.* at 559–60.
25. Thomas W. Joo, *Lehman 10 Years Later: The Dodd-Frank Rollback*, 50 LOY. U. CHI. L.J. 561 (2019).
26. *Id.* at 566 (citing Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 (2018)).
27. *Id.* at 562.

> Despite the supposed burdens of regulation, however, finance and real estate have gone well beyond mere recovery. They are arguably in . . . another overheated bubble phase, which deregulation may aggravate. Thus the law of finance enables and encourages the boom-and-bust cycle.[28]

Professor Joo's point makes sense in light of the lessons from the Great Financial Crisis: Powerful entrenched interests bent the law in their favor to seek profits over financial stability, and regulators contributed to the mania phase of the bubble by relaxing regulation at precisely the wrong time.

On the other hand, Gregory Gilchrist worries that prosecuting more bank executives is apt to net lower-level executives rather than c-suite executives.[29] He states: "Demanding more criminal prosecutions against individuals in cases of corporate misconduct will mostly impact relatively low-level offenders. The engineer, the site manager, the accountant—not the senior executive or director—bears the brunt of these policies."[30] Furthermore: "low-level prosecutions, even if deserved, accomplish little in terms of changing corporate culture."[31] Finally: "prosecuting lower-level employees for corporate misconduct risks aggravating the perceived accountability problem through the appearance of scapegoating, as senior personnel still evade punishment."[32] Professor Gilchrist theorizes that informational and power asymmetries within the corporation render the above outcomes likely.[33] He also suggests that prosecutors will seek easy corporate fines (and accompanying headlines) over difficult investigations that go up the ladder of corporate responsibility.[34] Gilchrist suggests that these factors explain the diminution of criminal accountability in the wake of the financial crisis.[35]

Professor Mary Ramirez leans the opposite direction.[36] She suggests that the essential "lawlessness" of the financial sector must face enhanced whistleblower protection.[37] Professor Ramirez also rates Dodd-Frank highly on this point:

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28. *Id.* at 597.
29. Gregory M. Gilchrist, *Accountability Lost and the Problem(s) of Asymmetry*, 50 LOY. U. CHI. L.J. 599 (2019).
30. *Id.* at 602.
31. *Id.*
32. *Id.* at 602–03.
33. *Id.* at 615.
34. *Id.*
35. *Id.*
36. Mary Kreiner Ramirez, *Whistling Past the Graveyard: Dodd-Frank Whistleblower Programs Dodge Bullets Fighting Financial Crime*, 50 LOY. U. CHI. L.J. 617 (2019).
37. *Id.* at 668.

> Dodd-Frank's whistleblower reforms are a positive feature of the 2008 financial crisis because they offer the potential for accountability against those who violate securities and commodities laws. That so many persons were aware of misconduct but failed to report it during the years leading up to the financial crisis suggests that either many members of society are willing to participate in lawlessness, even when it is not to their personal benefit, or that many are afraid and stay silent in the face of lawlessness. Given the high stakes for whistleblowers who may risk their jobs at a minimum and their careers, families, homes, and sanity in many circumstances, the effort to protect them from retaliation is an important step toward imposing a rule of law upon a lawless industry.

Ramirez suggests, however, that broad whistleblowing protection may operate so disruptively to the control of financial elites that they are likely to continue sustained attacks upon such protection over the long-term.[38]

Professor Wendy Couture enters this fray to suggest that criminal enforcement of the federal securities laws could become more expansive in certain circumstances if the government more aggressively used Section 17(a)(2) of the Securities Act of 1933 to impose criminal accountability.[39] The Supreme Court held that actions under that section do not require proof of scienter.[40] Professor Couture highlights an increased use of Section 17 in law enforcement proceedings.[41] She compares liability under Section 17 to the elements of a 10(b) claim and concludes that:

> As exemplified by the above six scenarios, these partially overlapping crimes, when analyzed side-by-side, potentially lead to anomalous results. Hopefully, this Essay will spark an ongoing conversation about potential reform, especially in light of the SEC's increased reliance on Section 17(a)(2) in civil enforcement and the potential that the DOJ may follow suit in criminal prosecutions.[42]

It remains to be seen if the use of Section 17 becomes more widespread by the SEC and DOJ.

Dean James Hackney provides a guided tour into the world of financial scientism.[43] Dean Hackney demonstrates the use of mathematical modeling of risk, including systemic risk, as a new regulatory tool, particularly at the Office of Financial Research, a creation of the Dodd-

38. *Id.* at 668.

39. Wendy Gerwick Couture, *Prosecuting Securities Fraud Under Section 17(a)(2)*, 50 LOY. U. CHI. L.J. 669 (2019).

40. *Id.* at 672.

41. *Id.* at 694.

42. *Id.*

43. James Hackney, *Regulating through Financial Engineering: The Office of Financial Research and Pull of Models*, 50 LOY. U. CHI. L.J. 695 (2019).

Frank Act.[44] He suggests, however, that too often economists and financial economists mistake the beauty of their complex models for some regulatory truth of knowable and controllable risks.[45] Hackney tends to favor direct regulation such as breaking up too big to fail banks.[46] The financial system, in other words, is not likely to be free of systemic risk like that seen in 2008, based upon magical mathematical models.[47]

Dean Christian Johnson presents a unique concern.[48] He worries that if "it" happened again, the Federal Reserve would be unable to respond to save the financial system as it did in 2008–09 with the use of nearly unlimited liquidity lending under Section 13(3) of the Federal Reserve Act.[49] "The power and discretion that Section 13(3) gave the Federal Reserve to lend hundreds of billions of dollars gave many policymakers and regulators pause."[50] As such, Congress endeavored to rein in the Fed's power and discretion in the Dodd-Frank Act.[51] Dean Johnson concludes that the Fed's success in taming the crisis led directly to the "great irony . . . that Congress could not move quickly enough to remove and limit the Federal Reserve's powers under Section 13(3) once the apex of the crisis had passed."[52]

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The essays and articles in this symposium issue take thoughtful and scholarly approaches to complex problems of financial regulation across a range of issues. One cannot escape the conclusion from this issue that the Great Financial Crisis of 2008 and the Dodd-Frank Act enacted in its wake constitute epochal events. The cautious optimism that the financial system operates more safely suggests that policy and law makers did learn valuable lessons from the crisis and successfully addressed the major challenges posed to financial stability that erupted in 2008. Ten years of stability and increasing prosperity attest to that success.

Yet, one can see the seeds of the next crisis in this symposium too: accountability of financial elites, risk cultures, regulation by mathematical models, the possible continuation of too big to fail, the need for further corporate governance improvements, the Dodd-Frank

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44. *Id.* at 695–701.
45. *Id.* at 714.
46. *Id.* at 695.
47. *Id.* at 714.
48. Christian A. Johnson, *From Fire Hose to Garden Hose: Section 13(3) of the Federal Reserve Act*, 50 LOY. U. CHI. L.J. 715 (2019).
49. *Id.* at 737–38.
50. *Id.* at 729.
51. *Id.* at 730.
52. *Id.* at 742.

rollback, and the limitations on the Fed each suggest risk going forward. Many issues and potential risks lie beyond the scope of this symposium; however, this symposium presents cutting-edge thinking on a range of important issues that could emerge from the fire next time.

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