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Overcoming Noneconomic Barriers to Loyal Disclosure

Paula Schaefer

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Overcoming Noneconomic Barriers to Loyal Disclosure

*Paula Schaefer**

I. Introduction

In 2003, following high-profile corporate scandals and heated public debate, the Securities and Exchange Commission (SEC) and the American Bar Association (ABA) adopted "loyal disclosure" rules.[1] These rules permit attorneys to reveal confidential information to protect an entity client from the illegal conduct of its own constituents.[2] Attorney discussion of how these rules will be utilized in practice centers around three concerns: (1) attorneys assume disclosure will always cause more harm than good for the entity client, (2) attorneys believe they cannot or should not determine that their own client's conduct is illegal, and (3) attorneys doubt that there is a person or entity to whom disclosure can be made to protect the client.[3] When these beliefs are combined with the fact that the new ethics rules allow but do not appear to require loyal disclosure,[4] attorneys practicing in

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*Assistant Professor of Business Law, Harmon College of Business Administration, University of Central Missouri.

[1]*See* George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients through Disclosure of Constituent Wrongdoing*, 11 Geo. J. Legal Ethics 597, 599 (1998) (defining loyal disclosure as "disclosure . . . justified not despite loyalty to the client but because it is in the client's interest.").

[2]17 C.F.R. § 205.3(d)(2)(i) and (iii) (2006); Model Rules of Prof'l Conduct R. 1.13(c) (2003) [hereinafter Model Rules]. *See infra* note 7 for the full text of the rules. The ABA and SEC do not use the terminology "loyal disclosure." *Id.* "Illegal conduct" falls within two categories: (1) client constituents violate a duty to the entity (such as fiduciary duty) and (2) client constituents violate a law, the violation of which may be imputed to the organization (such as fraud on a third party). *See supra* note 16.

[3]Attorney comments related to each of these barriers are discussed throughout Part III. *See generally infra* notes 78–219 and accompanying text.

[4]*See infra* notes 73–77 and accompanying text (explaining that, although the ethics rules *permit* loyal disclosure, an attorney's fiduciary duty may *require* loyal disclosure in a jurisdiction where it is ethically permissible).

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a loyal disclosure jurisdiction[5] may inappropriately dismiss the prospect of loyal disclosure without any serious analysis. These are the noneconomic barriers to loyal disclosure addressed in this article.[6]

Relying on the text and purpose of the rules, the attorney's position as a fiduciary and advisor, and other sources of law, this article provides attorneys with a more appropriate framework for evaluating the issue of loyal disclosure and proposes tools to address the genuine difficulties that attorneys face in meeting the rules' requirements. The result is a new construct for approaching the question of loyal disclosure.

This article considers these issues in three sections. Following this introduction, Part II explains the significant policy shift that loyal disclosure rules represent in the jurisdictions that adopt them, and it argues that in appropriate circumstances lawyers, as fiduciaries, must endeavor to use this new tool for protecting their entity clients. Part III then identifies the obstacles that prevent a meaningful consideration of loyal disclosure and proposes a new construct that attorneys should employ to address those issues. In doing so, it responds to the misapprehension that disclosure is always harmful to the client and both identifies and dispels common misconceptions about the meaning of the text of the rules. Further, Part III addresses the difficult question of how an attorney is to determine that client constituents are acting illegally as defined

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[5] *See infra* notes 33 (discussing applicability of the SEC loyal disclosure rule) & 62 (listing states that have adopted a loyal disclosure rule).

[6] This article's focus on the noneconomic barriers to loyal disclosure is not meant to disregard or downplay the significance of the economic barriers to loyal disclosure. An attorney disclosing illegal client conduct loyally is likely to suffer severe financial consequences: in-house attorneys are likely to be discharged and outside attorneys are likely to lose the client's business. These scenarios are likely given the setting in which this unique form of whistleblowing transpires, only occurring after the company's highest authority fails or refuses to respond to the attorney's reported concerns that the company is engaged in illegal conduct. *See infra* notes 40 & 66 and accompanying text. Others have focused on possible changes in the law that might address the economic impediments to loyal disclosure. *See, e.g.*, David McGowan, *Why Not Try the Carrot? A Modest Proposal to Grant Immunity to Lawyers Who Disclose Client Financial Misconduct*, 92 CAL. L. REV. 1825, 1825–26 (2004) (arguing that disclosure is costly, therefore, the amendments will not lead to disclosure until the rules address the costs of disclosure for lawyers); Rutheford B. Campbell, Jr. & Eugene R. Gaetke, *The Ethical Obligation of Transactional Lawyers to Act as Gatekeepers*, 56 RUTGERS L. REV. 9, 38–42 (2003) (asserting that there is an "inherent structural conflict" preventing lawyers from pursuing the best interests of corporate clients in that lawyers "depend on senior corporate officers for financial rewards" and suggesting that the problem can be addressed by requiring that an independent audit committee be charged with selecting counsel). Attorneys must address both the economic and noneconomic hurdles that may prevent them from disclosing confidential information to protect the entity client.

by the rules. Finally, it examines the issue of the people to whom disclosure can be made to protect the entity client. For those cases where an attorney determines that loyal disclosure is called for, Part IV discusses issues associated with executing a plan of loyal disclosure. Concluding, Part V offers some thoughts on the practical effect of these new loyal disclosure rules.

II. Understanding the Significance of a Jurisdiction's Adoption of a Loyal Disclosure Rule

While the rules vary slightly, both the ABA and SEC loyal disclosure rules provide that an attorney may disclose otherwise confidential information to a third party to protect the entity client from substantial injury caused by illegal conduct of client constituents.[7] Rather than seriously analyzing the

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[7]The loyal disclosure provision of the SEC rule provides:

> An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:
>
> (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; [or]
>
> (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006). *See also infra* note 36 (discussing the term "investors").

The loyal disclosure provision of the ABA Model Rules of Professional Conduct provides:

> Except as provided in paragraph (d), if
>
> (1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and
>
> (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,
>
> then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

Model Rules R. 1.13(c) (2003). *See also infra* note 15 (defining "authorized constituents" as those who are authorized to make decisions on behalf of the entity client). In this article, the phrase "client constituents" is often used to describe those authorized to act on behalf of an entity client.

appropriateness of loyal disclosure, some lawyers may focus on the permissive nature of the rules.[8] Dismissing loyal disclosure as "merely permissive" overlooks the purpose of the loyal disclosure rules and the significance of these rules for attorneys upholding their fiduciary duty to entity clients. These issues are discussed in this section.

A. Loyal Disclosure, the Entity Client, and an Attorney's Ethical and Fiduciary Duties

Loyal disclosure is an exception to confidentiality rules that otherwise prohibit revealing information "relating to representation of a client."[9] Unlike more common "adverse disclosure" rules that allow disclosure of client confidences to protect a third party from client misconduct,[10] loyal disclosure rules allow disclosure of confidential information to protect the entity client itself.[11] Adverse disclosure is allowed *despite* an attorney's normal duty of loyalty to the client.[12] In contrast, loyal disclosure is justified *because* it is loyal to the client.[13]

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[8]*See infra* note 73 and accompanying text.

[9]The "Confidentiality of Information" rule provides that attorneys "shall not reveal information relating to representation of a client" unless an exception applies or the client consents. MODEL RULES R. 1.6 (2003). The ethical obligation of confidentiality is related to but distinct from the evidence rule of attorney–client privilege. *See* MODEL RULES R. 1.6(a) cmt. 3 (2003) (explaining that the confidentiality ethics rule "applies in situations other than those where evidence is sought from the lawyer through compulsion of law" and noting that confidentiality is broader than privilege in that confidentiality "applies not only to matters communicated in confidence by the client but also to all information relating to the representation.").

[10]The ABA describes the exceptions to confidentiality contained in subsection b of Model Rule 1.6, the "Confidentiality of Information" rule, as "adverse disclosure" provisions. MODEL RULES R. 1.6 cmts. 6–15 (2003). Adverse disclosure is permitted, for example, to allow an attorney to protect a third party from "reasonably certain death or substantial bodily harm." MODEL RULES R. 1.6(b)(1) (2003).

[11]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006); MODEL RULES R. 1.13(c) (2003).

[12]*See* MODEL RULES R. 1.6 cmts. 6–15 (2003) (explaining each exception and why the interests protected override the client's interest in confidentiality). *See also* Harris, *supra* note 1, at 599 (explaining that adverse disclosure is justified on the theory that the lawyer's duty to the public to prevent harm from client wrongdoing outweighs the lawyer's duties of loyalty and confidence to the client).

[13]*See* Harris, *supra* note 1, at 601 ("[W]hile adverse disclosure must be justified by duties to the general public or third party victims that outweigh the lawyer's duties of confidence and

Even though loyal disclosure rules are relatively new, they are an extension of long-standing principles governing how lawyers represent entity clients.[14] An attorney who represents an entity owes his or her loyalty to the entity itself and not to the constituents who speak on behalf of the entity.[15] Ethics rules, even prior to the 2003 amendments, provide that constituents cease to speak on behalf of an organizational client when they intend to violate a legal obligation to the organization or violate a law when the violation reasonably might be imputed to the organization.[16] In these situations of illegal conduct of constituents, ethics rules tell attorneys to "proceed as is reasonably necessary in the best interest of the organiza-

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loyalty to her client, no such justification is needed for disclosure properly deemed loyal to the client's interests.").

[14]In contrast, attorneys representing clients who are natural persons should treat them as autonomous beings, who can choose to act illegally. *See* Laurie A. Morin, *Broken Trust and Divided Loyalties: The Paradox of Confidentiality in Corporate Representation*, 8 U. D.C. L. Rev. 233, 234–35 (2004) (explaining that ethics rules embrace individual dignity and autonomy and that this framework is appropriate when the client is a "living, breathing human being . . ."). Though an attorney cannot participate in a client's fraud and must withdraw from the representation if continuing will assist the client in illegal conduct, the attorney need not protect a natural person from himself or herself. *See* Model Rules R. 1.2(d) & 1.16(a)(1) (2003).

[15]Model Rules R. 1.13(a) (2003) ("A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."); 17 C.F.R. § 205.3(a) (2006). *See also* Restatement (Third) of the Law Governing Lawyers § 96(1) (2000) (explaining that an attorney representing an organization must follow the instructions of the "responsible agents" of the organization) [hereinafter Restatement]. Attorneys are required to accept the decisions of the authorized constituents, "even if their utility or prudence is doubtful." Model Rules R. 1.13 cmt. 3 (2002); Model Rules R. 1.13 cmt. 3 (2003). George Harris explains, "It is generally accepted, even made the explicit premise of the *Model Rules*, that the lawyer's duties to an organization are owed to the entity rather than to any constituent member thereof." Harris, *supra* note 1, at 600.

[16]Model Rules R. 1.13(b) (2003) ("If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act, or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization."). *See also* Model Rules R. 1.13 cmt. 3 (2003) (explaining that, although an attorney must ordinarily accept the decisions of constituents, an attorney who knows that the organization is likely to be injured "by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization.").

tion."[17] Consistent with this ethical obligation, an attorney's fiduciary duties[18] encompass an obligation to protect the entity client from illegal conduct of constituents.[19] Representation of an entity thus has been analogized to representation of an incompetent client whose guardian is misappropriating funds; an attorney's loyalty is owed to the incompetent client and not to the guardian.[20]

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[17]MODEL RULES R. 1.13(b) (2003). *See also* RESTATEMENT, *supra* note 15, at § 96(2) (providing that a lawyer "must proceed in what the lawyer reasonably believes to be the best interests of the organization" when the lawyer learns of a constituent's intent to act in a way that violates a legal obligation to the organization or likely to be imputed to the organization and that is likely to cause substantial injury to the organization). Similarly, the SEC rule directs that the attorney representing an issuer "owes his or her professional and ethical duties to the issuer as an organization." 17 C.F.R. § 205.3(a) (2006).

[18]*See generally* RESTATEMENT, *supra* note 15, at § 16 (explaining the attorney's fiduciary duties of care and loyalty). The duty of care requires the attorney to act with competence and diligence in pursuit of the interests of the client. RESTATEMENT, *supra* note 15, at §§ 16(2) & 52(1). Acting with undivided loyalty to the interests of the client encompasses many responsibilities, including keeping client information confidential, avoiding conflicts of interests, dealing with the client honestly, and not using any advantages arising from the relationship in a manner that is adverse to the client. RESTATEMENT, *supra* note 15, at § 16(3).

[19]*See, e.g.*, FDIC v. O'Melveny & Myers, 969 F.2d 744, 749 (9th Cir. 1992) (holding that the duty of care to the client includes "protect[ing] the client from the liability which may flow from promulgating a false or misleading offering to investors."), *rev'd on other grounds*, 512 U.S. 79 (1994), *on remand*, 61 F.3d 17 (9th Cir. 1995); FDIC v. Clark, 978 F.2d 1541, 1545–46 (10th Cir. 1992) (affirming a jury's verdict that the bank's attorneys were negligent based on evidence that they did not fully investigate and report to the board of directors allegations of fraudulent activities by bank officers); *In re* Am. Cont'l Corp., 794 F. Supp. 1424, 1453 (D. Ariz. 1992) (allowing a cause of action against attorneys who allegedly failed to take steps to prevent a corporation's regulatory violations); SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 712–13 (D.D.C. 1978) (holding that the attorneys' duty to the corporate client obligated them to take action to interfere with the consummation of a merger of corporations when the attorneys knew that financial statements relied upon by shareholders in the merger were inaccurate). *See also* Roger C. Cramton et al., *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 737 (2004) ("[A]s part of the duties of care, competence and diligence that an organization's lawyer owes to the organization, the lawyer is required to exercise reasonable care to prevent an organization's constituent from violating a legal obligation to the organization or causing harm to the organization by performing acts on behalf of the organization that will cause injury to it, such as by exposing the organization to criminal or civil liability."); Campbell & Gaetke, *supra* note 6, at 23 ("[T]he lawyer's loyalty to the entity client logically mandates some action to protect it from the harm occurring through or threatened by the constituent's actions.").

[20]Harris, *supra* note 1, at 638 ("The organizational constituent engaged in crime or fraud, like the malfeasant guardian, is in effect disabled by her criminal self-interest from speaking on behalf of the client.").

Determining the best interests of the entity client may seem complicated because of the competing interests of officers, directors, employees, and owners.[21] In this context, though, ethics rules give the attorney simple direction: the entity is the client and the entity's interest is in its constituents not acting illegally.[22] Some have reasoned that we treat entities differently from natural persons because entities owe their existence to the state; therefore, the entity owes a duty to the state to act legally.[23] As one commentator describes it, "[a company] is a creature of law made to serve limited social purposes. Since we are free to construct the character of these artificial persons, we should construct them for legal purposes as good citizens, persons who have internalized .... the obligation to obey even laws they do not like . . . ."[24]

Despite the traditional duty to protect the entity client from illegal conduct of constituents, loyal disclosure ethics rules are a relatively new

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[21]*See, e.g.*, Campbell & Gaetke, *supra* note 6, at 31 (opining that acting in the best interest of the client is difficult "due in large measure to the conflicting interests among the various parties that have investments in the corporation and are thus impacted by the outcomes of corporate transactions"); Robert A. Desilets, *The Model Rules of Professional Conduct and the Securities Attorney: Confidentiality, Confusion and the Need for Change*, 23 CAP. U. L. REV. 611, 630–32 (1994) ("The corporate structure is comprised of many varied and competing interests in the form of such constituency groups as officers, directors, and corporate shareholders. To complicate the matter, these groups' interests are often diametrically opposed .... To require the attorney to attempt to represent the numerous interests of each corporate group and to serve the best interests of the corporation itself is an extremely tall order.").

[22]MODEL RULES R. 1.13(a) & (b) (2003). *See supra* note 16 (describing how illegal conduct of constituents harms an entity).

[23]*See generally* Harris, *supra* note 1, at 651 ("The legitimate quid pro quo [for limited liability] may be that the legal system as a whole, including the lawyer engaged to represent the interests of the organization, will take that separate entity seriously."). Professor Morin has argued that a "social compact" is created by the state and the corporation—with the state creating the entity in exchange for the benefits the entity will provide to the investors and the economy. She urges that an organization's illegal conduct breaks the social compact and justifies the organization's attorney making adverse disclosure to protect the public and investors. Morin, *supra* note 14, at 235. This logic also supports loyal disclosure: when the organization's constituents act illegally and their actions may be imputed to the organization, the lawyer—whose duty is to the organization—must do what it is necessary to protect the organization from acting in a way that is not permitted by the social compact.

[24]Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185, 1199 (2003). Professor Gordon goes on to explain that "it follows that the manager who ignores or tries to nullify the valid objectives of law and regulation is not acting as a responsible or faithful agent of his principal, the good corporate citizen." *Id.* at 1200.

development. Traditionally, an attorney's ethical and fiduciary obligations to protect an entity client from illegal conduct of constituents ended when those duties conflicted with his or her obligation of confidentiality. Prior to 2003, the Model Rules contained no rule permitting loyal disclosure.[25] Instead, Model Rule 1.13 directed attorneys that, in acting in the client's best interest in the face of illegal conduct of constituents, disclosure was to be avoided.[26] Framed another way, when there was a conflict between lawyers' duties of confidentiality and client protection, confidentiality prevailed.[27]

B. Loyal Disclosure Under SEC Rule 205.3(d)(2)(i) and (iii) and Model Rule 1.13(c)

This preference for confidentiality even when it conflicted with protecting the entity client changed in 2003 when the ABA and SEC adopted loyal disclosure rules. This section briefly discusses the policy considerations that drove the ABA and SEC to adopt these rules and examines the text of the rules.

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[25]MODEL RULES R. 1.13 & 1.6(b) (2002). The pre-2003 version of Model Rule 1.6 included no exception to the duty of confidentiality that would have allowed the attorney to disclose confidences to protect an organizational client from constituent illegal conduct, other than if the illegal conduct that would cause "reasonably certain death or substantial bodily harm." MODEL RULES R. 1.6(b)(1) (2002).

[26]The rule provided that, in deciding how to proceed in the best interests of the organization when an attorney knows that illegal conduct of constituents is likely to result in substantial injury to the organization, "[a]ny measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization." MODEL RULES R. 1.13(b) (2002).

[27]Commentators argued that the rule was inimical to the true client's interests: "The decision to forbid the corporate lawyer publicly to disclose client confidences after intracorporate remedies prove futile cannot . . . be defended by citing the client's paramount interests. The client's interests are what we sacrifice." Stephen Gillers, *Model Rule 1.13(c) Gives the Wrong Answer to the Question of Corporate Counsel Disclosure*, 1 GEO. J. LEGAL ETHICS 289, 304 (1987). Professor Gillers also explains, "The [pre-2003 version of Model Rule 1.13] . . . make[s] an important if tacit assumption: *whenever* internal remedies for unlawful insider conduct prove unavailing, it is *always* preferable to require the client to suffer in silence rather than grant its lawyer the option of alerting persons outside the corporation." *Id.* at 299.

1. Background and Text of the SEC Loyal Disclosure Rule

In the wake of several massive corporate scandals,[28] Congress enacted the Sarbanes-Oxley Act of 2002.[29] Section 307 of the Sarbanes-Oxley Act directed the SEC to adopt minimum standards governing the conduct of attorneys practicing before the SEC.[30] Following lively debate during the comment period,[31] the SEC adopted Part 205[32] which includes provisions requiring attorneys appearing and practicing before the SEC in the representation of an issuer[33] to report "evidence of a material violation"[34] to

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[28]*See* Marianne M. Jennings, *The Disconnect Between and Among Legal Ethics, Business Ethics, Law, and Virtue: Learning Not to Make Ethics So Complex*, 1 U. ST. THOMAS L.J. 995, 997–1018 (2004) (discussing the corporate scandals of the time).

[29]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[30]15 U.S.C. § 7245. Section 307 specifically required the SEC to adopt provisions requiring a lawyer "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof.)" *Id.*

[31]The SEC received 167 comment letters. *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8,185, Exchange Act Release No. 47,276, Investment Company Act Release No. 25,919, 68 Fed. Reg. 6,249 (February 6, 2003), *available at* http://www.sec.gov/rules/final/33-8185.htm [hereinafter SEC Implementing Release]. *See also infra* notes 44–46 (describing comments received and considered by the SEC).

[32]Codified as 17 C.F.R. § 205 (adopted January 29, 2003, effective August 5, 2003).

[33]An "issuer" is a company whose securities are registered under or which is required to file reports under the Securities Exchange Act of 1934. 17 C.F.R. § 205.2(h) (2006). "Appearing and practicing" before the SEC includes transacting business with the SEC, representing an issuer in an SEC administrative proceeding, providing advice regarding securities laws or regarding a document that the attorney has notice will be filed with the SEC, and advising an issuer regarding whether a statement, opinion, or other writing is required under securities laws. 17 C.F.R. § 205.2(a) (2006). Commentators have noted that the rules broadly cover a number of people who do not typically understand themselves to be practicing before the SEC. *See, e.g.*, Cullen M. Godfrey, *The Revised Role of Lawyers After Sarbanes-Oxley*, 68 TEX. B.J. 932, 933–34 (2005); Cramton et al., *supra* note 19, at 741–51; Stephen Fraidin & Laura B. Mutterperl, *Advice for Lawyers: Navigating the New Realm of Federal Regulation of Legal Ethics*, 72 U. CIN. L. REV. 609, 624–26 (2003).

[34]"Evidence" is defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." 17 C.F.R. § 205.2(e) (2006). "Material violation" is defined as a "material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law." 17 C.F.R. § 205.2(i) (2006).

higher authorities of the corporation (commonly referred to as "up-the-ladder reporting" or "reporting up")[35] and permitting loyal disclosure.[36]

The loyal disclosure portion of the rule allows a lawyer to disclose confidential client information to the SEC "to the extent the attorney reasonably believes necessary" to prevent the client's commission of a "material violation" that is "likely to cause substantial injury" to the issuer client.[37] The rule also allows disclosure to the extent the lawyer reasonably believes necessary "to rectify the consequences of a material violation"

[35]Section 205.3(b) requires that an attorney report evidence of a material violation to the issuer's chief legal officer (or both the chief legal officer and the chief executive officer). 17 C.F.R. § 205.3(b)(1) (2006). The lawyer then must determine if he or she receives an "appropriate response," defined as a response as a result of which the attorney reasonably believes (1) there is no material violation, (2) that the issuer has adopted appropriate remedial measures, or (3) that the issuer has retained an attorney to review the material violation and either (i) has implemented that attorney's remedial recommendations or (ii) has been advised that the attorney may assert a "colorable defense" on behalf of the issuer. 17 C.F.R. § 205.2(b) (2006). If the lawyer reasonably believes that he or she has not received an "appropriate response," then he or she must report the evidence to the audit committee or a committee of disinterested directors or, if there is no such committee, to the board of directors. 17 C.F.R. § 205.3(b)(3) (2006). The lawyer may omit disclosure to the chief legal officer if it will be futile and report immediately under § 205.3(b)(3). 17 C.F.R. § 205.3(b)(4) (2006). A lawyer who does not reasonably believe that he or she received an appropriate response shall explain his or her reasons to the person to whom the report was originally made under § 205.3(b)(1), (3), or (4) (i.e., the chief legal officer, chief executive officer, or directors). 17 C.F.R. § 205.3(b)(9) (2006). Alternatively to reporting up under § 205.3(b), the lawyer may instead report evidence of a material violation to the issuer's qualified legal compliance committee, if one has been established by the issuer; if reporting under this section, the lawyer is not required to assess whether an appropriate response is received. 17 C.F.R. § 205.3(c) (2006).

[36]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006). *See supra* note 7 for full text of the rule. It is significant that sections (i) and (iii) allow disclosure not only to protect the "issuer" (i.e., the client) but also to protect "investors." It is not clear whether the reference to "investors" refers specifically to the investors of the issuer or generally to the investing public. Corporations Committee of the Business Law Section of the California State Bar, *Conflicting Currents: The Obligation to Maintain Inviolate Client Confidences and the New SEC Attorney Conduct Rules*, 32 PEPP. L. REV. 89, 104 (2004) ("It is unclear what investors the SEC intended to cover. The term might be limited simply to shareholders, but it could include holders of debt securities or even investors in the securities markets more generally."). Further, an attorney's fiduciary duty is owed to the entity and not to the shareholders of the entity. SEC Implementing Release, *supra* note 31, at 6306 (explaining that a lawyer does not owe a duty to the shareholders of an issuer and that the SEC "does not want the final rule to suggest it is creating a fiduciary duty to shareholders that does not currently exist."). For both of these reasons, this article refers to loyal disclosure as disclosure to protect the issuer and not disclosure to protect the investors. To the extent that disclosure might protect investors but not the issuer, such disclosure would be adverse and not loyal.

[37]17 C.F.R. § 205.3(d)(2)(i) (2006). *See supra* note 34 (defining "material violation").

(when the attorney's services were used in furtherance of the violation) that "caused or may cause substantial injury" to the financial interest or property of the issuer client.[38] This SEC rule expressly preempts state bar ethics rules to the contrary.[39]

Though not explicitly stated in the text of the SEC rule, it is implicit that disclosure outside the issuer can occur only after reporting-up efforts have failed; the rule only permits disclosure "to the extent" necessary, and disclosure would not be necessary if an attorney had not yet reported up the ladder and failed to receive an "appropriate response."[40] Further, there is no explicit provision prohibiting an attorney hired to investigate or defend a material violation from making loyal disclosure of that same violation;[41] but this is likely the SEC's intent, given that such lawyers do not have a reporting-up obligation.[42]

The SEC's Implementing Release, Part 205, states that the rule "is intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct."[43] The Release notes that the Commission received many comments favoring the proposed rule, including comments that a corporate client's confidentiality interest is not compromised by disclosure of serious illegality not remedied by the board, because the board in that situation should not be regarded as authorized to

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[38] 17 C.F.R. § 205.3(d)(2)(iii) (2006).

[39] The SEC Rule provides: "An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted to practice." 17 C.F.R. § 205.6(c) (2006). Nonetheless, some states have directed attorneys that disclosure to the SEC is a violation of state ethics rules. For a detailed discussion of the preemption question posed by the SEC loyal disclosure rules and state rules that prohibit disclosure, see Cramton et al., *supra* note 19, at 797–809.

[40] *See supra* note 35 (explaining the attorney's "reporting up" obligation under the SEC rule).

[41] *See* 17 C.F.R. § 205.3(d)(2) (2006).

[42] *Id.* § 205.3(b)(6) & (7) (providing that the attorney does not have an obligation to report evidence of a material violation to higher authorities when the attorney was: (1) retained or directed by the issuer's chief legal officer or qualified legal compliance committee to investigate evidence of a material violation or (2) retained or directed by the issuer's chief legal officer or qualified legal compliance committee to assert a colorable defense on behalf of the issuer in an investigation or judicial or administrative proceeding relating to evidence of a material violation).

[43] SEC Implementing Release, *supra* note 31, at 6296.

speak on behalf of the corporation.[44] The SEC responds to objections that the rule would undermine the confidential nature of the attorney–client relationship by pointing to confidentiality exceptions in the majority of jurisdictions and a lack of evidence that the attorney–client relationship has been undermined in those jurisdictions.[45] In fact, the SEC concluded that the "generalized concerns" about impacting the attorney–client relationship must yield to the greater public interest in disclosure under the circumstances contemplated by the rules.[46]

2. Background and Text of the ABA Loyal Disclosure Rule

From 1908 to 2003, the ABA often debated and sometimes revised its confidentiality rules.[47] Though an ABA committee proposed a loyal disclosure rule in 1982, the ABA rejected that proposal.[48] Instead, in

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[44] *Id.* at 6309.

[45] *Id.* at 6310–11. It should be noted that the rules to which the SEC refers are adverse disclosure rules—rules that permit disclosure of client confidences to prevent a crime or fraud, but which do not specifically provide a framework for doing so in the interest of the entity client. *See id.*

[46] *Id.* at 6311.

[47] For a history of the ABA's confidentiality provisions from the Canons of Legal Ethics to the Model Rules, particularly the debate concerning the exceptions to the general rule of confidentiality, see Cramton et al., *supra* note 19, at 779–82; Kenneth F. Krach, *The Client-Fraud Dilemma: A Need for Consensus*, 46 MD. L. REV. 436, 454–58 (1987); Ryan Morrison, *Turn up the Volume: The Need for "Noisy Withdrawal" in a Post Enron Society*, 92 KY. L.J. 279, 300–04 (2003/2004); Jolyn M. Pope, *Transactional Attorneys—The Forgotten Actors in Rule 1.6 Disclosure Dramas: Financial Crime and Fraud Mandate Permissive Disclosure of Confidential Information*, 69 TENN. L. REV. 145, 146–60 (2001); Daniel Walfish, *Making Lawyers Responsible for the Truth: The Influence of Marvin Frankel's Proposal for Reforming the Adversary System*, 35 SETON HALL L. REV. 613, 628–37 (2005).

[48] *See* Gillers, *supra* note 27, at 290–94 (discussing the evolution of ethics rules governing behavior of an organization's attorneys, none of which allowed disclosure of confidences to protect the client from illegal conduct of constituents). A 1982 draft of the Model Rules contained a loyal disclosure provision substantially similar to that adopted in 2003. It provided:

> [Action to be taken by lawyer to protect the client organization] may include revealing information otherwise protected by Rule 1.6 only if the lawyer reasonably believes that:
> (1) the highest authority in the organization has acted to further the personal or financial interests of members of that authority which are in conflict with the interest of the organization; and
> (2) revealing the information is necessary in the best interest of the organization.

RESTATEMENT, *supra* note 15, at § 96 cmt. f (citing MODEL RULES R. 1.13(c) (Revised Final Draft, June 30, 1982)). The ABA House of Delegates rejected this proposed loyal disclosure

adopting the Model Rules of Professional Conduct in 1983, the ABA became more protective of confidentiality, substantially limiting the circumstances where disclosure was permitted.[49] In August 2001, just months before the Enron debacle became public, the ABA House of Delegates rejected two proposed amendments to its confidentiality rule that would have allowed disclosure of client confidences to protect third parties from substantial financial injury caused by client crime or fraud.[50]

In March 2002, in light of Enron and other highly publicized corporate wrongdoing, the ABA president appointed the Task Force on Corporate Responsibility ("Task Force") to consider the issue of corporate governance.[51] In the months that followed, forty law professors urged the SEC to adopt its own attorney conduct rules,[52] the Sarbanes-Oxley Act

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provision when it adopted Model Rule 1.13 in 1983. Thus, when faced with illegal conduct of constituents, the only remedy available to lawyers under the Model Rules was to resign in accordance with Model Rule 1.6. Gillers, *supra* note 27, at 292–93. *See also* Morrison, *supra* note 47, at 306–07. *See infra* note 62 (listing four states that adopted and still follow that rejected loyal disclosure provision).

[49]In 1983 the ABA adopted the Model Rules to replace the Model Code of Professional Responsibility ("Model Code"). The Model Code provided that an attorney could disclose "the intention of his client to commit a crime and the information necessary to prevent the crime." MODEL CODE DR 4-101(c)(3). The Kutak Commission, the commission charged with studying the Model Code and suggesting its revision, had suggested adopting confidentiality exceptions that would have allowed attorneys to reveal confidential information "to the extent the lawyer reasonably believes necessary: . . . to prevent the client from committing a criminal or fraudulent act that the lawyer reasonably believes is likely to result in . . . substantial injury to the financial interests or property of another" and "to rectify the consequences of a client's criminal or fraudulent act in the furtherance of which the lawyer's services had been used . . . " Pope, *supra* note 58, at 154 (citing MODEL RULES R. 1.6(b) (Proposed Final Draft 1982)). These exceptions were rejected by the ABA in favor of a Model Rule that broadly defined an attorney's obligation of confidentiality and allowed an attorney to disclose client confidences only to protect a third party from "imminent death or substantial bodily harm" caused by a client's criminal act and to protect an attorney in controversies arising from dealings with the client. MODEL RULES R. 1.6(b) (1983).

[50]Herrick K. Lidstone, Jr., *Am I My Brother's Keeper? Redefining the Attorney–Client Relationship*, 32 COLO. LAW. 11, 13–14 (2003) (describing the decision by the ABA House of Delegates in 2001 to not allow the proposed amendment to Model Rule 1.6). *See also infra* note 61 (describing the 2003 amendment to Model Rule 1.6 to include these previously proposed but rejected exceptions).

[51]Final Report, ABA Presidential Task Force on Corporate Responsibility (March 31, 2003), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf, at 2–3 [hereinafter ABA Final Report].

[52]*See* Lawrence A. Hammermesh, *The ABA Task Force on Corporate Responsibility and the 2003 Changes to the Model Rules of Professional Conduct*, 17 GEO. J. LEGAL ETHICS 35, 37 (2003).

became law,[53] the SEC adopted the attorney ethics rules discussed above,[54] and the Task Force considered testimony and comments of attorneys and interested groups.[55] Ultimately, the Task Force proposed significant changes to Model Rule 1.6 (the "Confidentiality of Information" rule) and to Model Rule 1.13 (the "Organization as Client" rule).[56]

In explaining its recommended revisions to Model Rule 1.13, the Task Force emphasized that attorneys must recognize their duty is to the organizational client and not to the organization's agents.[57] The Task Force acknowledged that, if a lawyer is viewed by client representatives as an enforcer of law, it may create an atmosphere of arm's-length dealing that is "inimical to the lawyer's essential role as a counselor promoting the corporation's compliance with law."[58] Nonetheless, the Task Force concluded that there are "clearly defined circumstances in which other considerations take precedence."[59] The Task Force explained that confidentiality is valuable to an organizational client just as it is to individual clients, but that the organizational client may have a countervailing interest in its attorney's disclosure of its confidences when disclosure will protect the organization from substantial injury caused by a constituent's violation of law.[60]

In August 2003, the ABA House of Delegates voted to adopt the Task Force's suggested revisions to Model Rule 1.6, expanding the exceptions that allow adverse disclosure,[61] and to Model Rule 1.13, requiring up-the-

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[53]*See* ABA Final Report, *supra* note 51, at 6 n.10. The Sarbanes-Oxley Act of 2002 was adopted on July 30, 2002.

[54]*Id.* at 8 n.18. The SEC attorney ethics rules were adopted on January 29, 2003, effective August 5, 2003.

[55]*Id.* at 2 (discussing public hearings on proposed rule changes, oral and written testimony of 27 witnesses, and a variety of other comments received) & 47–52 (discussing comments related to confidentiality rule changes).

[56]*See generally id.*

[57]*Id.* at 23.

[58]*Id.*

[59]*Id.*

[60]*Id.* at 56–57.

[61]*See id.* at 77–82 (showing comparison of prior and proposed versions of Model Rule 1.6). In 2003, Model Rule 1.6(b) was revised to add two additional exceptions permitting adverse disclosure of confidential information:

ladder reporting and permitting loyal disclosure.[62] The ABA's revised Model Rule 1.13 rule directs an organization's attorney to "proceed as is reasonably necessary in the best interest of the organization"[63] when the attorney "knows facts from which a reasonable lawyer, under the circumstances, would conclude" that a constituent of the organization "engaged in action, intends to act, or refuses to act" in a "violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization."[64] Unless it is not "reasonably necessary in the best

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> (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client used or is using the lawyer's services;
> (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services.

MODEL RULES 1.6(b) (2003).

[62]*See* ABA Final Report, *supra* note 51, at 82–89 (showing comparison of prior and proposed versions of Model Rule 1.13); MODEL RULES R. 1.13 (2003). Thirteen states have adopted the 2003 amendment of Model Rule 1.13(c). ARIZ. ST. S. CT. R. 42 R.P.C. R. 1.13; ARK. R. R.P.C. R. 1.13(c); CONN. R.P.C. R. 1.13(c); IDAHO R.P.C. R. 1.13(c); IND. ST. R.P.C. R. 1.13; IOWA R. 32:1.13(c); LA. ST. BAR ART. 16, R.P.C. R. 1.13(c); NEB. R.P.C. R. 1.13(c); N.D. ST. R.P.C. R. 1.13(c); OR. R.P.C. R. 1.13(c); S.C. R. A. CT. R. 407, R.P.C. R. 1.13(c); UTAH R., R.P.C. R. 1.13(c); WASH. R., R.P.C. 1.13(c). Four states have a similar loyal disclosure rule based on a 1982 proposal that was rejected by the ABA House of Delegates. N.H. R.P.C. R. 1.13(c); N.J. R. R.P.C. R. 1.13(c); MD. R. 16-812, M.R.P.C. 1.13(c); MICH. R. M.R.P.C. R. 1.13(c). RESTATEMENT, *supra* note 15, at § 96 cmt. f. *See supra* note 48 (containing text of the rejected rule). An attorney's licensing jurisdiction does not necessarily provide the substantive ethics rule; it is necessary for attorneys to consider a jurisdiction's choice of law rule (normally a version of Model Rule 8.5) to determine the applicable substantive ethics rule. For a discussion of the assortment of issues that arise in determining choice of law in this context, see generally Mary C. Daly, *Resolving Ethical Conflicts in Multijurisdictional Practice—Is Model Rule 8.5 the Answer, an Answer, or No Answer at All?*, 36 S. TEX. L. REV. 715 (1995).

[63]The 2002 version of Rule 1.13(b) likewise required the attorney to "proceed as is reasonably necessary in the best interest of the organization" in these circumstances, but directed attorneys that measures taken should be designed to minimize the risk of revealing information outside of the organization. MODEL RULES R. 1.13(b) (2002).

[64]Model Rule 1.13(b) provides:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is

interest of the organization to do so" the attorney is required to report the legal violation to higher authorities in the organization, including the highest authority if warranted by the circumstances.[65]

Loyal disclosure is only permitted under Model Rule 1.13 when up-the-ladder reporting fails, that is, when the highest authority capable of acting either insists upon or fails to timely and appropriately address "an action or a refusal to act that is clearly a violation of law."[66] Then, the lawyer may disclose confidential information if the attorney "reasonably believes" the conduct that is clearly a violation of law "is reasonably certain to result in substantial injury to the organization," but such disclosure is allowed "only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."[67] The rule does not limit the recipients of disclosure.[68] The ABA rule does not permit disclosure by an attorney investigating the alleged violation of law or defending the organization or any of its constituents against a claim arising out of an alleged violation of law.[69]

> reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.

MODEL RULES R. 1.13(b) (2003).

[65] *Id.*

[66] *Id.* at R. 1.13(c)(1) (emphasis added).

[67] *Id.* at R. 1.13(c)(2).

[68] *Id.*

[69] Model Rule 1.13(d) states, "Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law." *Id.* at R. 1.13(d). (2003). *See also id.* at R. 1.13 cmt. 7 (explaining that subparagraph d "is necessary in order to enable organizational clients to enjoy the full benefits of legal counsel in conducting an investigation or defending against a claim."); ABA Final Report, *supra* note 51, at 59.

C. Conclusions about an Attorney's Obligation to Critically Analyze the Appropriateness of Loyal Disclosure

A jurisdiction's adoption of a loyal disclosure rule represents a significant shift in policy: when an attorney's duty to protect the entity from illegal conduct of constituents conflicts with the duty of confidentiality, the attorney is now ethically permitted to protect the entity by revealing its confidences.[70] Both the ABA and SEC recognized entity clients have a general interest in confidentiality, but they determined that the client has a greater interest in being protected from illegal conduct of constituents, even when that protection means disclosure of confidences.[71] While some may question the wisdom of this policy choice,[72] it is inappropriate for an attorney to continue to absolutely prefer confidentiality in a jurisdiction that has adopted a loyal disclosure rule.

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[70] *See supra* notes 25–27, 37–38, & 66–67 and accompanying text (discussing the traditional preference for confidentiality even when disclosure would protect the entity client and the shift to a preference for disclosure when it will protect the entity client).

[71] *See supra* notes 43–46 & 57–60 and accompanying text (discussing the policy behind the ABA and SEC adoption of loyal disclosure rules).

[72] Many have asserted that loyal disclosure rules will make client representatives less likely to confide questionable conduct, which may harm an attorney's ability to dissuade them from acting illegally. *See* Harris, *supra* note 1, at 652 ("The policy consideration most often articulated in opposition to any expansion of lawyers' 'whistle-blowing' responsibilities is that such responsibilities would be destructive to the attorney–client relationship."); Stanley Pietrusiak, Jr., *Changing the Nature of Corporate Representation: Attorney Liability for Aiding and Abetting the Breach of Fiduciary Duty*, 28 St. Mary's L.J. 213, n.45 (1996) (explaining the fear that loyal disclosure rules will cause constituents to view the entity's attorney as the "town blabbermouth," thus undermining the corporate structure); SEC Implementing Release, *supra* note 31, at 6310 (discussing comments that disclosure rules "would undermine the relationship of trust and confidence between lawyer and client, and may impede the ability of lawyers to steer their clients away from unlawful acts."); ABA Final Report, *supra* note 51, at 47–48 (discussing comments that emphasized the need to protect the trust and confidence that is fundamental to the attorney–client relationship and necessary for the attorney to represent the client effectively).

Out of concern about such issues, some jurisdictions have rejected loyal disclosure rules. For example, a Missouri bar committee charged with considering the ABA's 2003 amendments recommended that Missouri not adopt the ABA loyal disclosure rule. One reason cited by the committee is that the proposed rule "undermines the attorney client relationship within an organization. Employees reporting to an attorney would have little confidence that the confidential information disclosed would remain confidential." Letter from Joe B. Whisler, President, Missouri Bar, to Honorable Ronnie L. White, Chief Justice, Supreme Court of Missouri (Oct. 11, 2004) (on file with author) [hereinafter Missouri Letter]. The Missouri Supreme Court has not adopted a loyal disclosure provision. Mo. R. Bar R. 4-1.13.

Lawyers who view the rules as only "permitting" but not "requiring" disclosure[73] are focusing too closely on the ethics rules themselves and not considering how those rules impact an attorney's fiduciary duty to an entity client. With the ethical prohibition against loyal disclosure lifted, there is a compelling legal argument that failing to use loyal disclosure (in cases where it would have protected the entity client from constituent misconduct) is a breach of the duty of care[74] and of the duty of loyalty[75] to the entity client.[76] With the prospect of such liability in a loyal disclosure jurisdiction,[77] attorneys now must critically analyze the appropriateness of loyal disclosure.

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[73]*See, e.g.*, *Developments in the Law: Corporations and Society, IV. Lawyer Conduct and Corporate Misconduct*, 117 HARV. L. REV. 2227, 2245–46 (2004) [hereinafter *Lawyer Conduct*] (explaining that, because the SEC and ABA rules are permissive, "lawyers will have few incentives to exercise their reporting right; indeed, lawyers will have strong economic incentives to please the managers of their current or potential clients by refraining from reporting, even if their inaction allows questionable activity to go unchecked.").

[74]Failure to use loyal disclosure would breach the duty of care if a reasonably competent and diligent attorney would have used loyal disclosure under the circumstances. *See* RESTATEMENT, *supra* note 15, at §§ 16(2) & 52(1) (discussing an attorney's duty of care).

[75]A jury may find an attorney breached the duty of loyalty if it determines the attorney chose to protect the confidences of constituents regarding their plans to engage in illegal conduct to the detriment of the entity client. *See* RESTATEMENT, *supra* note 15, at § 16(3) (discussing an attorney's duty of loyalty to the client).

[76]*See also* Jenny E. Cieplak & Michael K. Hibey, *The Sarbanes-Oxley Regulations and Model Rule 1.13: Redundant or Complementary?*, 17 GEO. J. LEGAL ETHICS 715, 721 (2004) ("Where a violation is material and so egregious that any objective observer would find credible evidence of that violation, it is doubtful that the discretion to not report the violation is really desired by the true clients of the attorney–the corporation and its investors."); Harris, *supra* note 1, at 601 ("If one takes the entity theory seriously, there will be at least some instances where disclosure of constituent wrongdoing to other constituents of the organization, including shareholders, or even outside the organization, to government agencies or potential third party victims, would prevent substantial harm to the organization and would be, therefore, loyal to its interests as an entity."); Susan P. Koniak & Geoge M. Cohen, *In Hell there will be Lawyers without Clients or Law*, 30 HOFSTRA L. REV. 129, 142–43 (2001) (arguing that remaining silent when constituents are acting illegally "may leave lawyers vulnerable to liability.").

[77]In contrast, in a jurisdiction that prohibits loyal disclosure, an attorney would have a defense to a claim that the attorney should be liable for failing to use loyal disclosure to protect the entity client. *See* RESTATEMENT, *supra* note 15, at § 54(1) ("A lawyer is not liable . . . for any action or inaction the lawyer reasonably believed to be required by law, including a professional rule."). *See also* Harris, *supra* note 1, at 607–08 (explaining that the former version of Model Rule 1.13, which did not permit disclosure to protect the client, would provide a defense to an action seeking liability for failure to make loyal disclosure). These defenses are inapplicable in a loyal disclosure jurisdiction.

III. The Noneconomic Barriers to Loyal Disclosure and the New Construct

I now turn to the noneconomic barriers that prevent attorneys in loyal disclosure jurisdictions from appropriately analyzing the loyal disclosure question. The following sections discuss each obstacle and together create a new framework for lawyers to employ in determining the appropriateness of loyal disclosure.

A. Barrier 1: Assumption that Maintaining the Entity Client's Confidences is Always in the Entity Client's Best Interest

Attorneys' skepticism that the entity client can be protected from substantial injury through loyal disclosure is colorfully described by one attorney:

> [The ABA concluded] that the lawyer not only had an obligation to go up the corporate ladder, but that the lawyer was free, when the lawyer had gone up the corporate ladder and the lawyer's recommended course of action was not endorsed by the organization's board, to then disclose what was happening at the corporation in order to protect the corporation! The lawyer had permission to disclose confidential information beyond the client, even to the constabulary. Not unlike the idea of protecting our oil fields by setting them on fire![78]

This fear is echoed by attorneys who point out that disclosure of illegal client conduct will be detrimental to the client's relations with investors, regulatory agencies, suppliers, customers, and creditors.[79] They note that disclosure may lead to the client's investigation, prosecution, civil liability, criminal conviction, or at the very least, fear that creates the impression—and then the reality—of a company in financial trouble.[80] In short, many

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[78]Lawrence J. Fox, *Can Client Confidentiality Survive Enron, Arthur Andersen, and the ABA?*, 34 Stetson L. Rev. 147, 157 (2004).

[79]Gillers, *supra* note 27, at 299 (explaining that this is a common defense of the assumption that silence is always better than disclosure).

[80]*See, e.g.*, McGowan, *supra* note 6, at 1830 ("If the lawyer stays silent, the client might get lucky and use the fraudulently obtained funds to turn its business around. If it did, investors would not lose money, and no one would be the wiser. Disclosing, however, could signal to capital markets, trade creditors, and others that the client is in trouble. That perception could become a self-fulfilling prophecy: disclosure might trigger the collapse that would then create the expected cost of litigation, while silence might forestall or avoid it entirely").

lawyers simply assume that disclosure of illegal conduct is necessarily harmful to the entity client, so it can never be in the client's interest.

Such a preference for silence somewhat ironically ignores the entity's interest in acting legally.[81] Disclosure that prevents illegal conduct by client constituents prevents harm to the client. This is the "substantial injury" the rules allow disclosure to prevent.[82] If disclosure will actually prevent illegal conduct that is prospective only, attorneys should have little fear that disclosure will result in other adverse consequences for the client.[83]

Even where illegal conduct is ongoing, disclosure cannot be assumed away. Just because disclosure may reveal past illegal conduct that may lead to adverse consequences like investigations, lawsuits, and liability does not mean that disclosure is not loyal to the entity client. Disclosure of a constituent's continuing violation of an obligation to the entity client (such as, for example, a constituent's continuing scheme of misappropriating client funds) directly benefits the entity. Further, when ongoing illegal conduct is harming a third party, disclosure will prevent illegal conduct that has not yet occurred, thus actually limiting the amount of client liability.[84] An attorney cannot change the fact of past illegal conduct, and its existence

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[81]*See supra* notes 14–24 and accompanying text.

[82]*See infra* notes 90–97 and accompanying text.

[83]*See* Gillers, *supra* note 27, at 301 (noting that, as long as criminal conduct is prospective, disclosure will not cause criminal conviction but will instead prevent it).

[84]*See id.* at 300 ("Where the highest authority is stealing large sums or valuable proprietary information from the client, or is seriously abusing the client's position or reputation to work misdeeds on third persons, disclosure which ends the conduct would on some occasions leave the client better off than silence."); Harris, *supra* note 1, at 600 ("Timely disclosure may benefit the organization by precluding or limiting that liability even though disclosure is adverse to the wrongdoing constituent."); Richard W. Painter, *Lawyers' Rules, Auditors' Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1419–20 (2000) ("[An organization's] managers may . . . prefer to take the risk of concealing the fact that the business is facing losses . . . [caused by] violations of the law, hoping that the business cycle, remedial measures, or sheer luck will bail them out. The legal risks of concealment and the risk that the problem could get worse while it is concealed might be preferred over the more certain costs of prompt disclosure. Prospect theory suggests that . . . managers may still choose to conceal even though concealment is not in . . . the organization's best interests."). Although the loyal disclosure rules do not allow an attorney to factor this into the analysis of determining the appropriateness of disclosure, disclosure may have the incidental benefit of additional scrutiny that leads to the discovery of other related misdeeds of constituents that are harming the entity client—even when those misdeeds are not "clearly a violation of law" or a "material violation."

should not impede his or her ability to use loyal disclosure to prevent future injury arising from continued illegal conduct.[85]

Another obstacle is the belief that the "substantial injury" language of the loyal disclosure rules actually supports a preference for silence. Recall that both the SEC and the ABA rules qualify an attorney's ability to disclose by stating that the illegal conduct planned by constituents must be "reasonably certain to result in" (under the ABA Model Rule) or "likely to cause" (under the SEC Rule) "substantial injury" to the entity client.[86] The rules permit disclosure only "to the extent the lawyer reasonably believes necessary" to prevent that substantial injury.[87]

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[85]The SEC rule also allows disclosure to the SEC to "rectify the consequences" of past illegal conduct that caused or may cause substantial injury to the client, if the attorney provided services to the client in that matter. 17 C.F.R. § 205.3(d)(2)(iii) (2006). While this discussion of future or ongoing illegal conduct does not apply to this provision, the new construct should otherwise be applied to the facts of a specific situation to determine if disclosure to the SEC will rectify the consequences of past illegal conduct.

[86]The SEC and ABA rules do not perfectly parallel one another, so for ease of understanding, the referenced provisions are in italics. MODEL RULES R. 1.13(c)(2) (2003) ("*the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury* to the organization, then the lawyer may reveal information relating to the representation ... but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.") (emphasis added); 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006) (an attorney "may reveal ... confidential information ... to the extent the attorney reasonably believes necessary ... (i) [t]o prevent the issuer from committing a material violation that is *likely to cause substantial injury* to the financial interest or property of the issuer or investors") & (iii) ("[t]o rectify the consequences of a material violation by the issuer *that caused, or may cause, substantial injury* to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.") (emphasis added). For simplicity, this section will generally refer to the language of § 205.3(d)(2)(i), but not § 205.3(d)(2)(iii); nonetheless, this discussion applies to both parts of the SEC rule. *See also* MODEL RULES R. 1(i) (2003) ("reasonably believes" denotes that the lawyer "believes the matter in question and that the circumstances are such that the belief is reasonable"); MODEL RULES R. 1(l) (2003) (defining "substantial" as a "material matter of clear and weighty importance.").

[87]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006) (an attorney "*may reveal ... confidential information ... to the extent the attorney reasonably believes necessary* ... (i) *[t]o prevent* the issuer from committing a material violation that is likely to cause *substantial injury* to the financial interest or property of the issuer or investors or (iii) *[t]o rectify* the consequences of a material violation by the issuer that caused, or may cause, *substantial injury* to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.") (emphasis added); MODEL RULES R. 1.13(c)(2) (2003) ("the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer *may reveal information relating to the representation ... but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury* to the organization.") (emphasis added).

Some lawyers have interpreted this language to mean that they should remain silent when illegality might result in a substantial *benefit* to the client (reasoning that disclosure is allowed only to prevent substantial *injury*).[88] They also interpret the language as discouraging disclosure when illegality might otherwise be undetected (reasoning that disclosure is not necessary to protect the client, because the client may "get away with" the conduct) or when disclosure itself might cause substantial injury to the client (reasoning that such disclosure does not protect against substantial injury, but instead causes it).[89]

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[88]Professor Harris suggests the following hypothetical case, which highlights attorney confusion about whether it is appropriate to consider the benefits to the entity of acting illegally:

> [C]ounsel for a savings and loan corporation becomes aware that it, through its CEO, is making risky investments of depositors' funds in violation of the law and is fraudulently hiding that fact from depositors and federal regulatory agencies. Assume further that the CEO . . . refuses to disclose it or take steps to remedy its consequences. The scheme, if undetected, may actually benefit the corporation financially should the risky investments pay off. On the other hand, if the investments result in losses, the scheme may bankrupt the corporation with resulting harm to the corporation's shareholders and its depositors (or the federal taxpayers who insure them) . . . . Would such disclosure be loyal or adverse to the interests of the corporation?

Harris, *supra* note 1, at 600–01. *See also* Lauren C. Cohen, Note, *In-House Counsel and the Attorney–Client Privilege: How Sarbanes-Oxley Misses the Point*, 9 STAN. J.L. BUS. & FIN. 297, 297–303 (2004). Ms. Cohen uses a hypothetical situation in which the company executives inform in-house counsel (also a board member) that they are "cooking the books" and need to continue to "project an image of financial stability" so that a merger that could save the company can proceed. *Id.* at 297–98. Ms. Cohen asserts that the hypothetical counsel will believe that it is in the "best interest of the corporation . . . to go ahead with the merger as [counsel] see[s] no other possible way of saving the company." *Id.* at 303.

[89]*See* Monroe H. Freedman, *The "Corporate Watch Dogs" That Can't Bark: How the New ABA Ethical Rules Protect Corporate Fraud*, 8 U. D.C. L. REV. 225, 225, 231 (2004) (arguing that if an attorney believes that a constituent's "fraud is not likely to be found out" and that "revealing the fraud outside the company is likely to cause substantial injury to the company (i.e., prosecution and/or civil suits)," then disclosure is forbidden under the 2003 version of Model Rule 1.13(c)). *See also* Mark Aultman, *Legal Ethics Rules and Corporations: What's 'Client' Got to Do With It?*, 33 CAP. U. L. REV. 49, 55 (2004). Mr. Aultman criticized Model Rule 1.13's substantial injury language as follows:

> If the corporate determination is that profits outweigh potential harm to the public, and it is better for the corporation to fight individual lawsuits as they arise, then a disclosing lawyer would be violating ethics rules in almost every situation where there is an ongoing enterprise. It is only where the client implodes, as with Enron, or a lawsuit later results in *very* substantial damages, that it becomes clear that the wrongful activity was likely to cause substantial harm to the corporation.

These interpretations of the "substantial injury" language were not intended by the drafters of the SEC and ABA rules. Instead, the question of whether illegal conduct is reasonably certain to result in (or likely to cause) substantial injury and whether disclosure is necessary to prevent it are meant to distinguish minor legal violations from major ones. In discussing the violations that should be reported up under Sarbanes-Oxley, which mandated the SEC's adoption of attorney conduct rules, Senator John Edwards stated that "no reporting is required for piddling violations or violations that don't amount to anything."[90] The ABA Task Force Final Report[91] and the SEC Implementing Release[92] demonstrate a similar intent for their loyal disclosure rules: disclosure is appropriate to prevent serious violations of law because these are the violations that cause "substantial injury."[93] Neither the ABA nor the SEC rules

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Id. Aultman's comment is directed at the pre-2003 version of Model Rule 1.13, which did not contain a loyal disclosure provision, so it is likely that his reference to "disclosure" refers to reporting within an organization. Nonetheless, his comments are relevant to the issue of attorneys' interpretation of "substantial injury."

[90]148 CONG. REC. S6552 (daily ed. July 10, 2002) (remarks of Sen. Edwards). *See also Lawyer Conduct*, *supra* note 73, at 2232 (citing the Edwards statement and concluding that "only fairly serious violations will trigger a reporting duty").

[91]*See, e.g.*, ABA Final Report, *supra* note 51, at 44 ("[Model Rule 1.13] provides instruction in the extraordinary circumstance of a significant failure of governance that puts or threatens to put the interest of the organization into serious legal jeopardy. . ..") & 57–58 ("The Task Force agrees that [confidentiality rules] should not be understood to preclude controlled disclosure beyond the organization in the limited circumstances where the wrongdoing is clear, the injury to the client organization is substantial, and disclosure would clearly be in the interest of the entity client.").

[92]SEC Implementing Release, *supra* note 31, at 6311–12 (explaining that the final adopted disclosure provision is intended to respond to commentator concerns that disclosure should only be permitted when the information in question appears to have "a material impact on the value of the issuer's securities" and that, accordingly, the adopted rule applies to "material violations that are likely to cause substantial injury to the financial interest or property of the issuer or investors.").

[93]*See* Irma S. Russell, *Keeping the Wheels on the Wagon: Observations on Issues of Legal Ethics for Lawyers Representing Business Organizations*, 3 WYO. L. REV. 513, 530 (2003) (explaining that Model Rule 1.13(b) "seems to limit its application to *significant circumstances* by the element that the conduct 'is likely to result in substantial injury to the organization.'") (emphasis added); Cieplak & Hibey, *supra* note 76, at 721 ("Some may argue that the attorney still has no choice of actions once he has discovered the material violation. This is because the exercise of discretion actually lies in determining whether the violation is *important enough to force him to take action.*") (emphasis added).

contemplate weighing the benefits of illegal conduct or the likelihood of detection.[94]

It follows that the "substantial injury" language conveys that, although all illegal acts of an entity are improper, only serious violations should be reported up and, if no appropriate response is received, ultimately disclosed outside of the entity client through loyal disclosure. Whether conduct is "likely to cause" or "reasonably certain to result in" substantial injury is a question of whether *when this type of conduct is discovered* it is likely to cause or reasonably certain to result in a serious or minor injury.[95] Essentially, the attorney must approach uncertain future events by assuming that the conduct will be revealed regardless of the attorney's disclosure.[96] Using this approach, an attorney's analysis should proceed as follows: Is this the sort of illegal conduct that if and when it is discovered is likely to cause or reasonably certain to result in substantial injury, or only a minor injury? And is there someone to whom I can disclose this

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[94]*See* ABA Final Report, *supra* note 51; SEC Implementing Release, *supra* note 31.

[95]Professor Russell's analysis of Model Rule 1.13(b)'s reporting-up provisions is consistent with this interpretation of the language. She urges that a lawyer "should not conclude that Model Rule 1.13 requires silence by the lawyer in the face of a violation of the law that he believes would not be discovered. To adopt such an interpretation traps the lawyer in a relationship of conspiracy." Russell, *supra* note 93, at 531. Professor Russell instead advocates an interpretation that "compliance with the law is in the long-term self-interest of the client and ... violating the law is against the long-term self-interest of the client, even when discovery is unlikely." *Id.* She concludes that this reading of the rule requires an attorney to conclude that breaking the law is " 'likely to result in substantial injury to the organization' even if the violation is not likely to be discovered or prosecuted in the foreseeable future." *Id.*

[96]Professor Harris explains that betting on nondetection is not the appropriate role for the organization's attorney:

> Assuming that [an attorney's determination that the client is acting illegally] is correct, it is difficult to imagine the responsible, non-complicit grounds for failing to take remedial steps. The grounds for difference of opinion would presumably be differing views as to the likelihood of detection and the significance of resulting liability. Could it be truly said that the corporate officer who bets on lack of detection and/or lack of resulting harm to the organization is not complicit in the wrongdoing? .... Where detection and liability do come about, the innocent shareholders ... are unlikely to be satisfied by the acquiescence of the *lawyer* who knew about the wrongdoing.

Harris, *supra* note 1, at 642 (emphasis added).

information who can prevent that conduct, thus preventing the substantial injury?[97]

Abandoning a preference for silence does not mean that all illegal conduct of constituents must be disclosed to the world regardless of the risks to the entity client. Loyal disclosure rules ultimately are concerned with client protection, which means stopping illegal conduct in a way that minimizes risks to the client (i.e., disclosure "to the extent necessary" to protect the client). These concerns are best addressed not by making a blanket assumption against loyal disclosure, but instead by making an appropriate selection of the recipient of loyal disclosure. This selection of recipient question is discussed below.[98]

In conclusion, the first part of this thoughtful new approach to loyal disclosure requires attorneys to recognize that entity clients have an interest in acting legally. It also eliminates any misconceptions about the "substantial injury" language of the loyal disclosure rules. Understanding the appropriate circumstances for loyal disclosure, an attorney can then address the difficult issue of whether the entity client's conduct is, indeed, illegal as defined by the loyal disclosure rules.

B. Barrier 2: Attorneys' Belief that They Should Not or Cannot Conclude that the Entity Client's Constituents are Acting Illegally

Some attorneys are challenged by the belief that it is not within their ability to determine when constituents of their own client are acting illegally:

> Now, I do not want to appear before you and tell you that I am in favor of fraud. I am not. I am against fraud. But I also want you to know that it is one of the easiest statements to make: if a lawyer sees fraud, and people are getting defrauded, we should have those lawyers stop that fraud . . . . The problem is, fraud doesn't look like fraud . . . Whatever else it is, fraud is at worst hidden and at best, ambiguous. Fraud is only clear with the benefit of hindsight.[99]

This statement reflects the legitimate concern that illegality—whether termed a "material violation" (under the SEC rule) or "clearly a violation of law" (under the ABA rule)—encountered in business is impossible

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[97]Under part (iii) of the SEC rule, the attorney may also ask if disclosure to the SEC will rectify the consequences (substantial injury that already occurred or may occur) of serious illegal conduct. 17 C.F.R. § 205.3(d)(2)(iii) (2006).

[98]*See infra* notes 173–219 and accompanying text.

[99]Fox, *supra* note 78, at 156.

or at least difficult for an attorney to determine.[100] A related view is that lawyers are advocates and not judges; thus, they should not be "deciding" that client conduct is illegal.[101] These issues are addressed here in two parts: first, explaining why attorneys should determine whether constituents are engaged in illegal conduct and, second, demonstrating that attorneys can make such a determination, even in factually and legally complex scenarios such as those involving fraud and breach of fiduciary duty.

1. Attorneys *Should* Determine Whether Their Entity Clients' Constituents Are Acting Illegally

Some attorneys oppose loyal disclosure because they believe it is inconsistent with their role as a zealous advocate: that it is not the attorney's job to decide if conduct is illegal, but instead to find an argument that the client's chosen course is legal.[102] In objecting to the attorney conduct provisions of the Sarbanes-Oxley Act, one attorney stated that it "wrongly puts corporate attorneys in the role of judge rather than advocate."[103]

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[100]Another example of this view is reflected in Professor Morin's argument that attorneys who facilitated the "special purpose entity" transactions for Enron executives may not have known they were assisting in fraudulent activity:

> As far as we know, the individual transactions [Enron Chief Financial Officer Andrew] Fastow asked the attorneys to facilitate may have been unorthodox but not illegal. Prosecutors recognize that in order to establish criminal fraud, they will have to show that Enron's executives intended the overall picture to be misleading to investors or regulators. Although several officers of the corporation have pleaded guilty to intentional fraud, it remains to be seen whether the attorneys knowingly participated in the crime.

Morin, *supra* note 14, at 247.

[101]*See infra* notes 102–03 and accompanying text.

[102]Gordon, *supra* note 24, at 1194 (asserting that the corporate lawyer views himself as an advocate whose job it is "to help [clients] pursue their interests and put the best construction on their conduct that the law and facts will support . . . , so as to enable them to pursue any arguably-legal ends by any arguably-legal means."); Christin M. Stephens, *Sarbanes-Oxley and Regulation of Lawyers' Conduct: Pushing the Boundaries of the Duty of Confidentiality*, 24 St. Louis U. Pub. L. Rev. 271, 296 (2005) ("The most frequently cited argument against permissive disclosure is that it would harm the attorney's ability to zealously represent the client."); SEC Implementing Release, *supra* note 31, at 6310 (noting that those who opposed the loyal disclosure provision argued that " 'it is not a lawyer's job' in representing an issuer . . . 'to correct or rectify the consequences of [the issuer's] illegal actions, or even to prevent wrongdoing.' ").

[103]Lidstone, *supra* note 50, at 14 (quoting Jeffrey Kindler, general counsel for Pfizer). *See also* Alfred P. Carlton, Jr., *Lessons from Enron: A Symposium on Corporate Governance October 17, 2002 Morning Session*, 54 Mercer L. Rev. 683, 710 (2003) (quoting former American Bar Association

Advocacy is not the lawyer's only role. For purposes of the loyal disclosure rules, an attorney should be acting as an advisor, not as an advocate. Advocacy is appropriate in the context of litigation where attorneys are expected to make all nonfrivolous arguments available to prove the client's claims or to defend claims against the client.[104] But courtroom advocacy is checked by an opponent's ability to respond to those arguments and the judge or jury's ability to decide which version of the facts is more credible.[105] Loyal disclosure rules do not apply to attorneys engaged in litigation; they apply to attorneys who are advisors to entity clients in a nonlitigation context.[106] There, none of the checks of the litigation process are present, making aggressive advocacy inappropriate.[107] Such advocacy may even assist a client in perpetrating criminal or fraudulent conduct, which is prohibited by ethics rules.[108]

In adopting loyal disclosure rules, the ABA and SEC envisioned attorneys playing the role of advisor: independently determining whether conduct is illegal, advising the client constituents about those determinations, and then, when necessary, taking action to prevent harm to the client

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President Bill Ide: "Some of us have a strong concern that if you erode the [attorney–client] privilege too far, we will turn lawyers into auditors ... The result would be destruction of a critical component of our justice system—the lawyer as an advocate.").

[104]*See, e.g.*, Cramton et al., *supra* note 19, at 766–67 ("In our system, advocates are required to put the other side, particularly if that side is the government, to its proof. They are privileged to put forth all nonfrivolous justifications of their clients' conduct and all nonfrivolous arguments that the law should be read in novel, even unprecedented, ways. When they represent clients charged with civil or criminal wrongs, they may offer 'colorable defenses.'").

[105]*Id.* at 770.

[106]*See supra* note 69 and accompanying text (discussing the ABA prohibition against loyal disclosure in a litigation context). The SEC rule does not explicitly contain this prohibition, but it appears to be implicit in the SEC rule. *See supra* notes 41–42 and accompanying text.

[107]Cramton et al., *supra* note 19, at 770 (arguing that in the advisory role—with none of the protections of the litigation process—it is inappropriate for an attorney to counsel a client "that it can act based on some unprecedented vision of what the law requires or some barely plausible interpretation of the facts."). *See also* Fred Zacharias, *Lawyers as Gatekeepers*, 41 San Diego L. Rev. 1387, 1391 (2004) ("At a minimum, lawyers owe clients information, including information that suggests that the clients' proposed or completed conduct is criminal (or wrongful in other respects).").

[108]Model Rules R. 1.2(d) (2003). Campbell & Gaetke, *supra* note 6, at 29 (explaining that for corporate lawyers, the prohibition against counseling or assisting in illegal conduct is part of the attorney's gatekeeper duties).

by disclosing that illegal conduct.[109] While an attorney must defer to the client's constituents when their conduct is not illegal (even if the prudence of their conduct is doubtful),[110] the attorney has a duty to the entity to use his or her training and skills to determine what is illegal and to protect the client from that conduct.[111] This is what the ABA Task Force on Corporate Responsibility wanted: "The recommendations in this Report relating to lawyers are intended to enhance the lawyer's ability to exercise and bring to bear *independent professional judgment*, and thereby enhance the lawyer's ability to promote corporate responsibility . . . ."[112]

Further, as a fiduciary of the entity client, an attorney is an appropriate person to determine whether questionable conduct is illegal. At its core, the duty of loyalty means not preferring the interests of someone else over the interests of the client.[113] It is inconsistent with an attorney's duty of loyalty to the entity client to try to "find a way" to argue that constituents' questionable conduct is legal—particularly when the attorney is concerned that the constituents are harming the company for their own benefit or subjecting the company to substantial liability.[114] For example,

[109]ABA Final Report, *supra* note 51, at 24–25. The Task Force explained that an attorney's promotion of corporate responsibility is consistent with the Model Rules' direction that an attorney should act "[a]s advisor [to] provide[] a client with an informed understanding of the client's legal rights and obligations and explain[] their practical implications." ABA Final Report, *supra* note 51, at 21, quoting Model Rules Preamble ¶ 2. *See also supra* notes 43–46 & 57–60 (discussing the policy reasons cited by the SEC and the ABA in adopting the loyal disclosure rules).

[110]*See supra* note 15. *See also* Gillers, *supra* note 27, at 297 ("Shareholders elect board members who run the corporation. Corporate counsel may or may not agree with management decisions, but it is not their role to manage. If . . . a final decision is made to pursue a lawful course that the corporate lawyer considers inimical to the client's interests, the lawyer has, and should have, no recourse.").

[111]Harris, *supra* note 1, at 642 ("Deference by the organization's lawyer to the business judgment of the organization's authorized representatives is certainly the general rule . . . . A determination that constituents of the organization are engaged on behalf of the organization in crime or fraud with significant likely adverse consequences for the organization is, however, peculiarly within the province of the lawyer's expertise and duty to the client.").

[112]ABA Final Report, *supra* note 51, at 24–25 (emphasis added). *Id.* at 34 ("In formulating recommendations relating to the role of lawyers, the primary goal of the Task Force has been to enhance the ability of lawyers to promote compliance with law.").

[113]*See supra* note 18 and accompanying text (defining the duty of loyalty).

[114]Harris, *supra* note 1, at 638 ("Unlike the case of adverse disclosure, where loyalty to the client must be balanced against a duty to prevent harm to the public, the lawyer's disclosure

one commentator has explained how an Enron lawyer might have acted differently if he had approached the situation from the perspective of a fiduciary of the company:

> A lawyer looking out for the best interest of the corporation should have been at least curious about the purpose for creating the partnerships and whether they were good for the health of the company and its shareholders. But a lawyer with loyalty to [Enron executive] Fastow would have every incentive to rely on the "business judgment" of Fastow and his creative team, and to turn a blind eye to any suspected irregularity in the transactions they were asked to facilitate . . .[115]

Though it focuses on loyalty, this comment also raises the question of whether properly discharging the attorney's duty of care means undertaking additional investigation to protect the client.[116] When faced with uncertainty about whether a constituent's proposed conduct is legal, it might be tempting to avoid learning additional facts that would then have to be considered.[117] However, a fiduciary should investigate the facts and research applicable law to draw an informed conclusion.[118] While there

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[in the interest of the organizational client] would be loyal to the client as well as to the public. *There would be no competing duty to protect the organization's wrongdoing constituent.*") (emphasis added).

[115]Morin, *supra* note 14, at 247.

[116]Attorneys who opposed Missouri's adoption of a loyal disclosure rule were concerned that such a rule might create a duty to investigate client misconduct. They urged the bar committee to recommend against adoption of the rule, arguing that "it is uncertain what duties of investigation the attorney may have if he obtains partial information that indicates disclosure is necessary." Missouri Letter, *supra* note 72, at 4.

[117]*See* Campbell & Gaetke, *supra* note 6, at 54 (arguing that the standard for knowing illegality provided by Model Rule 1.13 "tends to promote a course of willful blindness on the part of the corporate lawyer, even when managerial misconduct might be suspected."); Morin, *supra* note 14, at 245–46 ("The structure of the modern-day legal profession helps to facilitate . . . ostrich-like behavior. Increasing specialization makes it less likely that any one attorney understands the 'big-picture' of the corporation's goals and operations. In-house attorneys may handle the day-to-day work, with highly technical tasks parceled out to outside counsel. Most of the attorneys in this vast network are unlikely to have access to top executives or directors, and are unlikely to have much cross-pollination with one another . . . ."); Zacharias, *supra* note 107, at 1393 ("There is a hard question; namely, the extent to which lawyers should investigate clients' motives and conduct in an effort to uncover illegality that they should counteract.").

[118]The Task Force explicitly denied that the rules require the attorney to investigate. ABA Final Report, *supra* note 51, at 43. Nonetheless, attorneys should be mindful that an attorney's fiduciary duty is not defined solely by the ethics rules. *See, e.g.*, Sean Geary, *Outside Professionals Representing Financial Institutions: An Overview of the Legal Bases for and Effects of Increased*

are undoubtedly obstacles to such an investigation, as where work is divided among numerous law firms,[119] a lawyer should be guided by the fiduciary duties owed to the entity in determining the extent of additional investigation that is required to protect the client.[120]

2. Attorneys *Can* Determine Whether Their Entity Clients' Constituents Are Acting Illegally: Tools for Determining Illegality for Purposes of Loyal Disclosure

Even if attorneys accept that it is appropriate for them, as advisors and fiduciaries, to determine that their own client is acting illegally, they still face the challenge of *how* to make that determination. The public debate about illegal business conduct often assumes that it is simple for attorneys to label conduct "illegal." In comments to the Senate in support of an attorney conduct provision in the Sarbanes-Oxley Act, Senator John Edwards argued that, if attorneys "see the law being broken or about to be broken," they should be required to "ensure that the law is being followed."[121]

Regulatory Action, 12 ANN. REV. BANKING L. 515, 529 (1993) (asserting that it is not enough for an attorney to merely follow the ethical rules because "the minimally accepted conduct that avoids disbarment" is not the standard required of a fiduciary) (quoting Office of Thrift Supervision's Chief Counsel Harris Weinstein). The Task Force does acknowledge, "Although the lawyer is under no duty to investigate or inquire, however, the lawyer may not simply accept such information at face value if to do so would be unreasonable in the circumstances." ABA Final Report, *supra* note 51, at 43. *See also* Cramton et al., *supra* note 19, at 756–57 ("A growing number of decisions impose liability when the lawyer relied on the word of the alleged wrongdoer without further inquiry; failed to inquire when a number of suspicious circumstances would have stimulated action by a prudent and competent lawyer; failed to report illegal activities by the client's managers to its board of directors; turned a blind eye to facts that were plain to see; or failed to take steps to prevent a continuing violation of law."); Fraidin & Mutterperl, *supra* note 33, at 660–61.

[119] *See, e.g.*, Gordon, *supra* note 24, at 1193 (noting that lawyers' claims of limited knowledge are plausible in the context of situations in which companies like Enron spread legal work to over 100 law firms).

[120] Robert W. Gordon asserts that lawyers should question whether they can "exercise their functions as fiduciaries" when organizations diffuse responsibility to prevent access to the "big picture." *Id.* at 1194.

[121] 148 CONG. REC. S6552 (daily ed. July 10, 2002) (remarks of Sen. John Edwards). Similarly, Senator Michael Enzi, Edwards' cosponsor of the attorney ethics provision of the Sarbanes-Oxley Act, suggested, "[T]here ought to be some kind of an ethical standard put in place for the attorneys ... Maybe it could be called the 'smell test.' If something smells wrong,

A simplistic view of the law—and attorneys' ability to know definitively what is illegal—ignores the complexity of legal violations that take place in the business world.[122] Attorneys advising business clients seldom declare conduct "illegal." This is true perhaps of all lawyers, not just those who view themselves as advocates, because attorneys recognize that there are many factors that determine what is illegal and because they, as attorneys, are typically not the final arbiters of legality. Instead, lawyers advise their clients as to what judges, juries, or regulators will likely, possibly, or probably conclude about the law as it applies to the facts of a given situation.[123] These attorneys are rightly confused about what standard they

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somebody who can do something to fix it ought to be told." 148 CONG. REC. S6552 (daily ed., July 10, 2002) (remarks of Sen. Michael Enzi).

[122]Despite all that has been written about loyal and adverse disclosure, the literature reflects the difficulty that commentators have articulating a factual and legal scenario in which an attorney would know that legally questionable conduct is, in fact, illegal. Articles discussing disclosure of client confidences often assume the attorney knows with a high level of certainty that conduct is illegal or pose a scenario of a "black and white" legal violation. *See, e.g.*, Desilets, *supra* note 21, at 615 ("While it is not inherently burdensome to maintain the confidentiality of attorney–client communications, this requirement becomes infinitely more difficult when the securities attorney ... *is made aware of a fraud in the transaction* ... .") (emphasis added); Harris, *supra* note 1, at 638 ("That constituents of an organization are engaged in fraud or other criminal wrongdoing and that the wrongdoing will create significant harm to the organization ... will in many circumstances be exceedingly difficult determinations for the organization's lawyer to make .... *Assuming, however, that a lawyer has made these determinations* ... .") (emphasis added) & 601 ("[A]ssume that counsel for a corporation discovers that the corporation is regularly disposing of hazardous substances in knowing violation of environmental regulations."); Morin, *supra* note 14, at 235 ("[T]he shift in loyalties that I am proposing would only come into play in those relatively rare situations *where the lawyer knows to a certainty that the client is determined to follow a course of criminal or fraudulent conduct* .... ") (emphasis added); Russell, *supra* note 93, at 532 ("For example, many environmental laws require that a corporate official certify that information is true, such as a certification that discharge levels are within the levels established by a permit issued under the Clear Air Act or the Clean Water Act."). The absence of guidance in the literature is evidence of the difficult question posed by the task of deciding that business conduct is "clearly a violation of law" or a "material violation."

[123]The problem is perhaps best articulated in these examples from Koniak and Cohen:

> Understanding what the law demands may sometimes be a simple matter: when the light is red, the law demands that you stop. But that is certainly not always so. Lawyers presumably advised Microsoft that the way it was responding to its competitors did not violate the antitrust laws, but the Justice Department's lawyers believed otherwise. Whether or not Microsoft's business practices were legal or illegal was the subject of an intense courtroom battle. There was a final judgment on the matter, but that judgment does not end the difficult questions about the limits of lawful responses

should apply to make their own determination that certain conduct is, in fact, illegal for purposes of loyal disclosure.[124]

If attorneys are to make loyal disclosures to protect entity clients—particularly in the difficult areas of fraud and breach of fiduciary duty envisioned by the loyal disclosure rules—they need meaningful guidance about how to determine illegality. This section proposes an analytical model for dealing with that issue. First, it considers the slim guidance provided by the SEC and ABA loyal disclosure rules. Then, it considers how litigation standards can be employed to determine illegality for purposes of loyal disclosure.

a. Guidance provided by the loyal disclosure rules. The legality question has two parts: First, what types of illegal conduct trigger disclosure? Second, how does an attorney determine the conduct is illegal? Stated another way, how certain must the attorney be that the conduct is illegal?

To answer the first question, the SEC rule is triggered by a "material violation," while the ABA rule is triggered by conduct that is "clearly a violation of law."[125] A "material violation" includes securities law violations, breaches of fiduciary duty, or a "similar material violation of any United States federal or state law."[126] The ABA rule allows disclosure of a

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> to competitors. It is not that there is no law on the matter—antitrust law exists—but its contours are not easy to discern; thus, obedience is no simple task.

Koniak & Cohen, *supra* note 76, at 134. *See also* Fraidin & Mutterperl, *supra* note 33, at 669 ("[T]he definition of what is legal or illegal is often subject to substantial uncertainty. Securities lawyers can in good faith counsel clients and believe that the advice they have given is legal and ethical even though in hindsight such advice is found to be otherwise. This can be because the law (case law or regulatory law) developed in ways the lawyer may not have anticipated."); Gordon, *supra* note 24, at 1204 (explaining that even corporate lawyers who view themselves as advocates concede that lawyers "must advise the client of the risks of adventurous interpretations of law and fact, that decision-makers (if they ever find out) may . . . find the client in violation of the law.").

[124] *See, e.g.*, Patrick H. Pugh, *The SEC Standards of Professional Responsibility for Attorneys: A Balanced Solution to Noisy Withdrawal*, 14 Kan. J.L. & Pub. Pol'y 659, 666–67 (2005) (arguing that an attorney who "reasonably believes that a fraud is ongoing and discovered some credible evidence that the managers are engaged in fraudulent action . . . cannot meet the definition of 'knows,' and thus the attorney is not even permitted to begin the process of reporting within the organization.").

[125] 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006); Model Rules R. 1.13(c) (2003).

[126] 17 C.F.R. § 205.2(i) (2006). Breach of fiduciary duty is defined as "any breach of fiduciary duty or similar duty to the issuer recognized under an applicable Federal or State statute or at

constituent's violation of a legal obligation to the organization, as well as violations of law that reasonably might be imputed to the organization.[127] The Model Rules do not define or delimit the phrase "violations of law."[128]

The ABA and SEC rules do not directly answer the second question of how the attorney should analyze the facts and law to decide that conduct is illegal. The best guidance provided by the rules is in the related up-the-ladder reporting provisions. As prerequisites to loyal disclosure and because these provisions use similar language, they provide some insight into how the ABA and SEC intended attorneys to decide what is illegal for loyal disclosure purposes.

Under the SEC rules, "evidence of a material violation" is the triggering mechanism for up-the-ladder reporting, but only a "material violation" enables loyal disclosure.[129] The difference between the two standards is significant. Evidence means "credible evidence based upon which it would be unreasonable" for an attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur.[130] Thus, while an attorney should report up *evidence* based

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common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions." *Id.* § 205.2(d).

[127] MODEL RULES R. 1.13(b) & (c) (2003).

[128] *Id.*

[129] *Compare* 17 C.F.R. § 205.3(b)(1) (2006) (duty to report "evidence of a material violation" to higher authorities) *with* 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006) (permitting disclosure to prevent a "material violation"). Commentators generally refer to the SEC attorney ethics rules as providing an "objective" standard of knowledge of a material violation. *See, e.g.*, Godfrey, *supra* note 33, at 935 (referring to the "evidence of a material violation" definition as creating an objective standard.); Morrison, *supra* note 47, at 294 ("The SEC sought to make this an objective standard. . ."). It is critical to recognize that the absence of the word "evidence" in the loyal disclosure rule means that this "objective" standard is not incorporated into the loyal disclosure portion of the rule.

[130] 17 C.F.R. § 205.2(e) (2006). Commentators have criticized this provision of the rule, arguing that the standard would have been clearer, more objective, and enforceable if it had provided that that the lawyer must report up when "confronted with information that a prudent and competent lawyer, acting reasonably under the circumstances, would conclude was credible evidence of a material violation." Cramton et al., *supra* note 19, at 752–54 (criticizing the rule's double-negative standard and ambiguous "reasonably likely" standard). *See also Lawyer Conduct*, *supra* note 73, at 2231 ("Section 307 simply mandated a rule requiring an attorney to report evidence of a material violation; it provided no guidance as to the type, credibility, or amount of evidence a lawyer must possess before this reporting duty is triggered. The SEC attempted to resolve this ambiguity but in the process adopted a triggering standard phrased as a convoluted double negative ... "). These problems are even more

upon which it is "reasonably likely" that a material violation has occurred, attorneys must have more than mere evidence for loyal disclosure. Loyal disclosure is allowed to prevent or rectify the consequences of a "material violation," not a "likely material violation."[131] This difference in terminology conveys that the attorney must have a higher level of certainty of a material violation for loyal disclosure.[132]

In its Implementing Release, the SEC explained that, when reporting up, the attorney need not "know" that the conduct is illegal or disclose only when the attorney concludes that there is a violation of law and "no reasonable fact finder could conclude otherwise."[133] According to the SEC, such a standard is too high for purposes of up-the-ladder reporting.[134] However, this higher standard appears to satisfy the heightened level of certainty required for loyal disclosure under the SEC rule.[135]

The up-the-ladder reporting provisions of ABA Model Rule 1.13 set out a negligence standard, requiring the attorney to report to higher authorities if the attorney "knows facts from which a reasonable lawyer, under the circumstances, would conclude" that a constituent is engaged in conduct that violates a legal obligation to the organization or a violation of law that reasonably might be imputed to the organization and that is likely to result in substantial injury to the organization.[136] The comment to the rule adds that "knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious."[137] In its Final Report, the ABA Task Force

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pronounced in the context of determining if conduct is a "material violation" for purposes of loyal disclosure.

[131]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006).

[132]Further, the phrase "reasonably believes" contained in the loyal disclosure provisions describes the attorney's belief that disclosure is necessary and *not* the attorney's belief that the conduct in question is a material violation. *Id.*

[133]SEC Implementing Release, *supra* note 31, at 6302.

[134]*Id.* ("That threshold for initial reporting within the issuer is too high.").

[135]*See infra* notes 157–59 and accompanying text.

[136]MODEL RULES R. 1.13(b) (2003). *See also id.* at R. 1.13(b) cmt. 3 ("Paragraph (b) makes clear . . . that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituents that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization.").

[137]*Id.* at R. 1.13 cmt. 3.

explained that the new rule attempts to clarify that the knowledge of facts is subjective, but that the determination of whether the conduct is illegal is objective.[138]

In contrast, the ABA loyal disclosure rule provides that the conduct in question must be "clearly a violation of law,"[139] a standard that requires attorneys to have a higher level of certainty than the knowledge standard for up-the-ladder reporting under Model Rule 1.13(b).[140] However, like the SEC loyal disclosure rule, the ABA rule does not explain how an attorney is to determine that conduct is "clearly a violation of law." The next subsection elucidates this question.

b. Tools for analyzing illegality. Despite their lack of direction, the ABA and SEC loyal disclosure rules assume that lawyers can make the determination that conduct is "clearly a violation of law" or a "material violation," respectively. To do so, attorneys must reject the mistaken assumption that their inability to predict the outcome in a courtroom equates to an inability to determine that conduct is illegal. Even though claims of fraud and breach of fiduciary duty are typically submitted to a jury,[141] an attorney is still capable of deciding if this type of conduct is illegal for purposes of loyal disclosure.[142] Lawyers should view the loyal disclosure rules as providing

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[138]ABA Final Report, *supra* note 51, at 42–43.

[139]Model Rules R. 1.13 (c)(1) (2003).

[140]ABA Final Report, *supra* note 51, at 58 ("The lawyer must have a heightened level of certainty as to the violation of law, and the actual or threatened violation must be 'clear.' ")

[141]*See, e.g.*, Sound Video Unlimited, Inc. v. Video Shack, Inc., 700 F. Supp. 127, 147 (S.D.N.Y. 1988) (noting that summary judgment was denied in order to allow the plaintiff to prove the alleged breach of fiduciary duty at trial); Central States Indus. Supply Inc. v. McCullough, 279 F. Supp. 2d 1005, 1043 (N.D. Iowa 2003) (genuine issues of material fact existed as to whether employee conduct constituted breach of fiduciary duty, precluding summary judgment); Baker v. Pfeifer, 940 F. Supp. 1168, 1183 (S.D. Ohio 1996) (genuine issue of material fact precluded summary judgment on investors' fraud claim).

[142]Koniak and Cohen explain:

> Uncertainty is inherent in law, if only because lawmakers cannot identify and address all possible problems in advance . . . . In counseling clients, lawyers must do more than read legal rules; they must use the stories embodied in court opinions, legislative debates and executive agency pronouncements to assess their client's proposed or past conduct. In assessing whether that conduct is legal or illegal, the lawyer must extrapolate and interpret. After all, the client's conduct will rarely, if ever, be precisely the same as the conduct that has already been ruled on by the courts or specifically contemplated by the

them with a license to play the role traditionally played by the judge, jury, and/or regulator.[143] With the ability to sit in judgment of the law and facts should come an obligation to apply the same rules that are applied by judges, juries, and regulators to decide if conduct is illegal.[144]

One framework for analysis is the summary judgment standard: a court can enter judgment when the material facts are not in dispute and judgment (here, a determination of illegality) is appropriate as a matter of law.[145] Summary judgment does not require selection from a number of available burdens of proof, because the facts are undisputed. Thus, if

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> legislature in enacting a rule. Thus, the lawyer is required to construct her own story —a story about stories told by others. In doing so, the lawyer in a sense makes law for the client.

Koniak & Cohen, *supra* note 76, at 134–35. *See also* David J. Beck, *Nature of Legal Malpractice*, 43 BAYLOR L. REV. 43, 50–51 (1991) (explaining that interpreting the law involves "discriminating judgment," and an attorney's advice about the law should be based on his "informed judgment concerning the issue." Even when the law is uncertain, "an attorney is obligated to undertake reasonable research to ascertain the relevant legal principles and make an informed decision.").

[143]Professor Gordon advocates such an approach for corporate counselors, asserting that they should:

> (a) Construe the facts and law of the client's situation as a sympathetic but objective observer such as a judge, committed to serving the law's spirit and furthering its public purposes, would construe them; (b) impute to the corporate client the character of the good citizen, who has internalized legal norms and wishes to comply with the law's legitimate commands and purposes while pursuing its own interests and goals; and (c) be based on an interpretation and practical application of the law to the client's situation that helps the client, so constructed, to satisfy rather than subvert the purposes of the law.

Gordon, *supra* note 24, at 1211.

[144]*See, e.g.*, SEC Implementing Release, *supra* note 31, at 6302 n.49 (quoting one commentator who asserted that the trigger for the SEC rule must be based on an attorney's conclusion that "there has been a violation and no reasonable fact finder could conclude otherwise"; the commentator argued that such a standard is necessary to prevent "disparate application of the rule.").

[145]FED. R. CIV. P. 56.01(c) ("The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits . . . show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law."). *See, e.g.*, Cramer v. Devon Group Inc., 774 F. Supp. 176, 182 (S.D.N.Y. 1991) (holding that summary judgment in the majority shareholder's favor was not precluded by the fact that state of mind was an issue, where the minority shareholder failed to make a showing of any wrongful intent on the part of the majority shareholder sufficient for a reasonable jury to find for the minority shareholder on the fraud claim).

summary judgment is appropriate as a matter of law,[146] the undisputed facts will provide a high level of certainty that the conduct is illegal. Summary judgment is rarely appropriate in a factually complex setting as would be the case with fraud or breach of fiduciary duty, because there are typically disputes about the facts.[147] Nonetheless, using the summary judgment standard may be workable for an attorney faced with loyal disclosure. For instance, the attorney may possess undisputed facts about the constituents' fraudulent intent based on information admitted to the attorney.[148] Just as would be the case in the context of litigation, a judge would consider a fact undisputed if it was admitted by the party.[149] Furthermore, if the attorney does not possess other information that would call a fact into question, that fact should not be considered disputed.[150]

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[146]When the law, as opposed to the facts, is unclear, the lawyer may be in doubt about how to proceed. While the summary judgment standard and the judgment as a matter of law standard discussed below provide a framework for considering how certain a judge is about the applicable facts, there is no similar guidance for how certain the judge must be about the law. Even when a judge is uncertain about the law, the judge still must make a legal decision. Counsel facing the prospect of loyal disclosure may feel less comfortable declaring the law in such a situation, though. Attorneys should be guided by two principles. First, they must recognize there is always some uncertainty in the law but that they have the skills to make a decision about the law, just as a judge would in the same situation. *See supra* notes 111 & 142–44 (discussing an attorney's ability to determine the applicable law). Second the loyal disclosure rules require a high degree of certainty that conduct is illegal. *See supra* notes 125–40 and accompanying text. For this reason, if the lawyer is still uncertain of the law even after making an effort to reach a decision on the issue, it is unlikely that the attorney has achieved the high level of certainty required for loyal disclosure.

[147]*See, e.g., supra* note 141 and accompanying text.

[148]*See, e.g.*, Philip L. Pomerance, *The Ethical Lawyer: Maintaining Integrity While Representing Health Care Clients Under Investigation or Before a Tribunal*, 33 J.L. MED. & ETHICS 375, 376 (2005). Mr. Pomerance explains that, when a client "admits that he has or is committing a fraud," the attorney has knowledge sufficient to trigger a disclosure obligation under Model Rule 3.3 (knowledge of fraud or crime on a tribunal) (citing Plunkett v. State, 883 S.W.2d 349, 352 (Tex. Ct. App. 1994), which holds that an attorney knew his client had acted fraudulently when the attorney reasonably believed the truth of the client's statement "three of the jurors have been bought and paid for."). Though Mr. Pomerance discusses knowledge of fraud on a tribunal, his analysis applies equally to an organization's attorney when a constituent admits fraudulent conduct.

[149]*See, e.g.*, Chicago Dist. Council of Carpenters Pension Fund v. P.M.Q.T., Inc., 169 F.R.D. 336, 341–45 (N.D. Ill. 1996) (finding that summary judgment is appropriate based on responses to plaintiff's requests for admissions).

[150]*See, e.g.*, Street v. J.C. Bradford & Co., 886 F.2d 1472, 1479 (6th Cir. 1989) (noting that Supreme Court jurisprudence requires the nonmoving party to present "affirmative evidence" to defeat a motion for summary judgment).

The facts of *Balla v. Gambro, Inc.*[151] provide an example of how an attorney could use this summary judgment framework for determining illegality. Roger Balla was general counsel and also director of regulatory affairs for Gambro, Inc., a seller of kidney dialysis equipment.[152] In July 1985, Gambro's German affiliate informed Gambro that it would be shipping certain dialyzers, noting "the clearances of which varied from the package insert" and stating that "[f]or acute patients, risk is that the acute uremic situation will not be improved in spite of the treatment."[153] Based on the information the German affiliate provided about the dialyzer shipment, Balla was able to determine and to advise company executives that the dialyzers did not comply with FDA regulations, making it illegal for Gambro to sell the dialyzers in the United States. When Gambro executives ignored his instructions, Balla informed the FDA of the company's plans to sell the dialyzers. The FDA seized the shipment.[154]

While Balla's disclosure was required under Illinois' adverse disclosure rule, which required disclosure to prevent a client from causing "death or serious bodily injury,"[155] it also could have been made under the ABA's loyal disclosure rule if that rule had been in effect in the jurisdiction at that time.[156] Indeed, Balla could have determined that the conduct was "clearly a violation of law" using the summary judgment standard. Balla possessed undisputed facts regarding the dialyzers, namely, statements by the manufacturer about the quality of the dialyzers and information about company executives' intent to sell them. Applying those undisputed facts to applicable law, Balla was in a position to determine that the dialyzers did not comply with FDA regulations, in other words, that selling the dialyzers in the United States was "clearly a violation of law."

Even in situations where the facts are disputed and the summary judgment standard inappropriate, an attorney still may be capable of

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[151]584 N.E.2d 104 (Ill. 1991).

[152]*Id.* at 105–06.

[153]*Id.* at 106.

[154]*Id.*

[155]*Id.* at 109.

[156]MODEL RULES R. 1.13(c) (2003). As a threshold issue, the conduct at issue fits the definition of the kind of illegal conduct that can be disclosed in that a constituent intends to commit a "violation of law which reasonably might be imputed to the organization." MODEL RULES R. 1.13(b) & (c) (2003).

determining that conduct is illegal with the high level of certainty required by the loyal disclosure rules. The "judgment as a matter of law standard" is used by judges to determine if an issue need not be submitted to a jury.[157] The required analysis is whether "no reasonable jury" could reach a given conclusion on the issue[158]; in loyal disclosure terms, no reasonable jury could conclude anything but that the conduct at issue is illegal. This is the standard that the SEC Implementing Release states is too high for purposes of up-the-ladder reporting.[159] But if this high standard could be met for purposes of loyal disclosure, the lawyer could feel comfortable that he or she had made a reasonable determination of illegality.

Using this approach, an attorney would have to consider the facts known to him or her, the legal elements needed to prove the offense, and the burden of proof that a jury would apply in such a case. If the attorney were to determine that no reasonable jury could find otherwise, then the attorney could conclude that the conduct is a "material violation" or "clearly a violation of law."

Time Warner Entertainment Company, L.P. v. Six Flags Over Georgia, LLC[160] provides the facts for a hypothetical case illustrating this analysis. In that case a limited partnership, Six Flags Over Georgia, owned an amusement park.[161] The Six Flags limited partnership was owned by a general

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[157]Fed. R. Civ. P. 50(a)(1) (judgment as a matter of law is appropriate when a party has been fully heard on an issue and there is "no legally sufficient evidentiary basis for a reasonable jury to find for that party on that issue"). A similar standard may be provided by a state's judgment as a matter of law rule or a state's directed verdict rule. *See, e.g.*, Mo. R. Civ. P. R. 72.01. *See also supra* note 146 (discussing how the attorney should approach uncertainty about the law).

[158]*See* Fed. R. Civ. P. 50(a)(1).

[159]SEC Implementing Release, *supra* note 31, at 6302 (rejecting a standard for purposes of up-the-ladder reporting that the attorney determine that "no reasonable fact finder could conclude otherwise."). *See also supra* note 134 and accompanying text.

[160]563 S.E.2d 178 (Ga. Ct. App. 2002) [hereinafter *Time Warner II*]. In its 2002 decision, the Georgia Court of Appeals reinstated in part its prior opinion that was vacated by the U.S. Supreme Court on the separate issue of punitive damages. *Id.* at 180 (citing Time Warner Entertainment Co., L.P. v. Six Flags Over Georgia, LLC, 537 S.E.2d 397 (Ga. Ct. App. 2000), *vacated*, 534 U.S. 801 (2001) [hereinafter *Time Warner I*]). The 2000 opinion contains a more detailed discussion of the evidence that was presented to the jury. *Time Warner I*, 537 S.E.2d at 402–16. This article cites facts from both opinions.

[161]*Time Warner II*, 563 S.E.2d at 180 n.1.

partner that managed the amusement park business[162] and a limited partner, which was itself a limited partnership owned by individual investors, who played no role in the park's management.[163] The suit alleged that the general partner breached its fiduciary duty to the limited partnership and its limited partner.[164]

If Six Flags Over Georgia's lawyer[165] had become aware of the conduct of the general partner, would the attorney have been able to conclude it was "clearly a violation of law"? The facts of the case are complex; the trial transcript and record considered on appeal was eighty volumes in length.[166] However, in brief, the jury was asked to consider whether the general partner breached its fiduciary duty by doing some or all of the following: deferring park maintenance; forgoing capital improvements needed to keep the park competitive, such as adding rides; buying real estate adjacent to the park for its own account and developing plans for a competing park; entering a contract making Coca-Cola the exclusive beverage of the theme park but withholding proceeds from that contract from the limited partnership; and charging the limited partnership with more

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[162]Six Flags Over Georgia, Inc. (SFOG) was the named general partner, but in their lawsuit the limited partnership and the limited partner alleged that Time Warner Entertainment Company, L.P. (TWE), acting through and in concert with its subsidiaries SFOG, Six Flags Entertainment Corporation (SFEC), and Six Flags Theme Parks, Inc. (SFTP) assumed the role of general partner. *Time Warner I*, 537 S.E.2d at 401–02. TWE created a subsidiary SFEC to own the stock of SFTC which owned a controlling interest in SFOG. *Id.* at 402–03. All of the entities were found liable for breach of fiduciary duty. *Id.* at 402 n.3.

[163]*Time Warner II*, 563 S.E.2d at 180 n.1.

[164]*Id.* The limited partnership and the limited partner alleged in the complaint that the general partner breached its fiduciary duty by "preferring its own financial interest over that of the partnership and of the limited partner." *Id.* The jury returned a verdict in favor of the limited partnership and the limited partner, finding a breach of fiduciary duty and awarding $197,296,000 in compensatory damages and $257,000,000 in punitive damages. *Id.*

[165]This hypothetical situation is framed from the perspective of a lawyer who understood himself or herself to be representing the limited partnership. Similarly, an attorney who understood himself or herself to be engaged in the representation of the general partner (also a business entity) or one of the general partner's affiliated companies (whose conduct was also at issue in the case) also would have considered this same conduct to determine if its client's constituents were engaged in illegal conduct that should have been reported up, and if no appropriate response was received and the other standards of loyal disclosure were met, then disclosed to protect its client. Some counsel engaged in this type of representation may in fact represent more than one entity and should consider all of those clients in determining reporting-up and loyal disclosure obligations.

[166]*Time Warner II*, 563 S.E.2d at 185.

than $4 million in meals and automobiles used by general partner executives.[167]

An attorney with knowledge of the general partner's conduct might suspect that the general partner was not fulfilling its fiduciary duty to Six Flags Over Georgia and its limited partner. However, determining that the general partner's conduct is "clearly a violation of law"[168] poses a more difficult question. For example, taking the issue of whether the general partner breached its fiduciary duty by forgoing capital improvements to the park, an attorney would have to consider whether the general partner was in fact forgoing necessary capital improvements, as well as any evidence tending to show that forgoing such improvements was appropriate (the general partner claimed that it was consistent with the partnership's goal of creating a loss for tax purposes) and any evidence tending to show that it was a breach of fiduciary duty (the evidence showed that the general partner had a financial motive to depress the value of the park).[169]

The conflicting evidence and inferences make the issue inappropriate for summary judgment under the standard discussed above. Further, given that a jury accepting the tax loss argument might reasonably conclude the general partner was not in breach of fiduciary duty, it is unlikely that applying the judgment-as-a-matter-of-law standard would result in a finding of a clear violation of fiduciary duty sufficient for loyal disclosure.

An attorney might, however, be able to use the judgment-as-a-matter-of-law standard to determine that conduct related to the Coca-Cola contract was a clear breach of fiduciary duty. Assume that counsel became aware that Coca-Cola paid $20 million for the exclusive right to market its product at Six Flag Over Georgia's theme park along with six other Six Flags parks owned by companies affiliated with the general partner.[170]

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[167] *Time Warner I*, 537 S.E.2d at 402–06.

[168] As a threshold issue, breach of fiduciary duty is the type of illegal conduct reportable under Model Rule 1.13(c) because it is a "violation of a legal obligation to the organization." MODEL RULES R. 1.13(b) & (c) (2003).

[169] *Time Warner I*, 537 S.E.2d at 405–06 & 408–10.

[170] *Id.* at 403. TWE entered an agreement to make Coca-Cola the official beverage of all seven Six Flags parks, contingent on TWE obtaining a controlling interest in Six Flags Over Georgia's general partner, SFOG. On the day that TWE obtained this interest, SFEC and Coca-Cola executed the final agreement making Coca-Cola the exclusive beverage of the park. *Id.* *See also supra* note 162 (explaining the relationship between TWE, SFEC, and the named general partner, SFOG).

Assume further that the attorney's investigation revealed that the contract with Coca-Cola was not entered in the name of the limited partnership but instead in that of a company with a controlling interest in the general partner, that the $20 million payment was denominated a "sponsorship fee," and that the limited partnership had received no portion of the fee.[171] Assume also that, even after being confronted about the Coca-Cola contract, the general partner refused to turn any portion of the $20 million over to the limited partnership, arguing that it was not a payment for partnership property but was payment for the services rendered to Coca-Cola in sponsoring the transaction with all seven theme parks.

Legally, a partner has a fiduciary duty to account to the partnership for all partnership profits.[172] But the question remains whether the "sponsorship fee" was partnership property. A lawyer considering loyal disclosure would need to decide what a jury would make of these facts. The evidence reveals that Coca-Cola would not have entered the agreement with an entity that did not have the ability to convey the right to market Coca-Cola in the Georgia park; this was an explicit requirement of the so-called sponsorship agreement. Despite the general partner's argument to the contrary, all of the facts point to the conclusion that the payment was for limited partnership property—the right to market Coca-Cola exclusively at the park—and not for a service. The limited partnership's attorney would thus be able to conclude that a reasonable jury could only find that the fee was paid for partnership property. In other words, a finding of breach of fiduciary duty would be appropriate under the judgment-as-a-matter-of-law standard.

Admittedly, the foregoing analysis may leave some thinking that the barrier to loyal disclosure has not been surmounted. Is the construct presented here only helpful in the rare circumstance where the law and facts lead to a clear answer, as when a general partner is effectively stealing from

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[171]*Id.* Six Flags' share of the fee should have been $2.8 million. *Id. See also supra* notes 113–15 and accompanying text (discussing a fiduciary's obligation to be loyal to the entity and not its constituents and to question the legality of their decisions rather than presuming that all decisions lie within their business judgment); *supra* notes 116–20 (discussing a fiduciary's obligation to investigate facts).

[172]*Time Warner I*, 537 S.E.2d at 406–07 ("Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from . . . any use by him of its property.").

a limited partnership? To some extent, the answer to this question is provided by the loyal disclosure rules themselves. The rules require a high level of certainty that conduct is illegal and nothing here changes that. Nevertheless, the model for assessing illegality presented here should help attorneys approach the issue differently. With a new frame of reference and tools for analysis, attorneys will be able to identify the appropriate circumstances, however rare, when questionable business conduct rises to the level of a "material violation" or a "clear[] violation of law."

C. Barrier 3: Selecting a Recipient of Loyal Disclosure

When an attorney has determined that client constituent conduct is illegal, he or she then must determine if and to what extent disclosure is necessary to protect the entity client.[173] When the attorney has done everything short of disclosure to protect the client, including reporting the illegal conduct up the ladder to the highest authority in the entity client without success,[174] the attorney is left with one critical question: *Whom else can I tell?*

This "recipient selection" issue presents the final noneconomic barrier to loyal disclosure. Choosing a recipient of loyal disclosure is especially difficult because the lawyer is faced with two challenges: telling a person or persons who can stop the illegal conduct to protect the client[175] and disclosing the information in a way that minimizes risk to

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[173]MODEL RULES R. 1.13(c) (2003) (the attorney may reveal confidential information "but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."); 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006) (the attorney may disclose "to the extent the attorney reasonably believes necessary" to prevent a material violation likely to cause substantial injury to the issuer or to "rectify the consequences of" a material violation that caused or may cause substantial injury to the issuer).

[174]*See supra* notes 35 & 63–65 (discussing up-the-ladder reporting requirements under the ABA and SEC rules).

[175]The SEC rule also permits disclosure to rectify the consequences of illegal conduct that caused or may cause substantial injury, when the attorney provided services related to that illegal conduct. 17 C.F.R. § 205.3(d)(2)(iii) (2006). This section of the article primarily discusses an attorney's disclosure of serious illegal conduct that is ongoing or that has not yet occurred, as permitted by both the SEC and the ABA rules. MODEL RULES R. 1.13(c) (2003); 17 C.F.R. § 205.3(d)(2)(i) (2006). It should be noted that, if an attorney represents an issuer that has already committed a material violation of law, the attorney should consider whether and how disclosure to the SEC (disclosure is allowed to no one else) would rectify the consequences of that material violation. 17 C.F.R. § 205.3(d)(2)(iii) (2006). If the question is answered in the affirmative, the attorney should consider how to minimize the risks of disclosure to the client and how to execute a plan of disclosure, as discussed in this section.

the client.[176] These dual goals of loyal disclosure are reflected in the rules' requirements that the attorney only disclose if and to the extent he or she reasonably believes necessary to prevent serious illegal conduct.[177] In short, preventing illegal conduct is not the only goal; limiting the extent of disclosure is in the client's interest because it protects confidentiality to the extent possible and minimizes the risks attendant to disclosure.

These seemingly inconsistent objectives of loyal disclosure—revealing the client's illegal conduct and protecting the client—are the reasons some attorneys prefer nondisclosure.[178] A related problem is that, even if the preference for confidentiality is abandoned, lawyers may believe it is impossible to select a recipient of loyal disclosure who can protect the client. This is because they view all confidentiality exceptions as allowing or requiring disclosure to "the authorities," which they perceive as inconsistent with protecting the client.[179] While the SEC rule only permits disclosure to the SEC,[180] the ABA rule leaves open the question of the people to whom disclosure can be made.[181] At least one state has cited this lack of direction about the recipient of loyal disclosure as a "fatal flaw" and a reason not to adopt the rule.[182]

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[176]This approach is consistent with that suggested by Stephen Gillers in his 1987 article advocating a loyal disclosure rule, though he did not term it as such. Gillers explained, "The extracorporate disclosure should be as restricted as possible, consistent with the goal of protecting the client." Gillers, *supra* note 27, at 305.

[177]*See supra* notes 90–97 and accompanying text (discussing the substantial injury language).

[178]*See supra* notes 78–80 & 88–89 and accompanying text.

[179]*See* text accompanying note 78 *supra* (noting that an attorney is permitted to disclose to the "constabulary."). *See also infra* note 182 (assuming the rule would allow disclosure to "law enforcement or other officials.").

[180]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006) (providing that disclosure can be made to the SEC).

[181]MODEL RULES R. 1.13(c) (2003) (not naming the recipient of confidential information); ABA Final Report, *supra* note 51, at 58 ("[C]ommunication of client information outside the organization must be limited to information reasonably believed to be necessary to prevent substantial injury to the organization that is reasonably certain to occur. In most circumstances, this limitation would permit communication only with persons outside the organization who have authority and responsibility to take appropriate preventive action.").

[182]Missouri Letter, *supra* note 72, at 5 ("It is unclear to whom and under what circumstances such disclosure can be made. The rule begs the critical question–does the lawyer now have an affirmative duty to disclose information to law enforcement or other officials or must he wait until asked? The rule's inherent ambiguity is a fatal flaw.").

This section first considers the reasons a lawyer might choose to make loyal disclosure to an owner and how that may minimize the risks to the client. Next, it considers the reasons that disclosure to a nonowner such as the SEC, other government authority, or third party, may be more appropriate.

1. Loyal Disclosure to Owners

Because Model Rule 1.13(c) does not limit the recipient of confidential information,[183] attorneys governed by this rule should consider whether loyal disclosure to an owner or owners could protect the entity client.[184] While the lack of owner identity and contact information certainly creates an obstacle to disclosure, this should not prevent attorneys from considering the appropriateness of disclosure to owners.[185] At least in the case of a solvent entity, the owners have the biggest financial stake in the success of the entity.[186] They also have the means to protect the entity from illegal conduct and a strong incentive to minimize harm to the entity.[187] Or, if another perspective is helpful, owners can bring suit against an attorney who does not take steps to protect the entity from the illegal conduct of constituents, including protection through disclosure in a loyal disclosure jurisdiction.[188] Loyal disclosure to owners gives them the opportunity to

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[183]MODEL RULES R. 1.13(c) (2003).

[184]Without loyal disclosure rules, such disclosures are not permissible unless the owner is also an authorized constituent of the organization. *See* MODEL RULES R. 1.13(a) (2003) (stating that organizations act through their "duly authorized constituents."); MODEL RULES R. 1.13 cmt. 2 (2003) (explaining that confidential information can be learned from many sources, but that keeping it confidential means limiting its communication to the authorized constituents of the organization).

[185]This problem is addressed in Part IV. *See infra* notes 220–33 and accompanying text.

[186]*See* Campbell & Gaetke, *supra* note 6, at 35 (arguing that the law of corporations dictates that interests of the entity "must be identified by reference to the interests of the corporation's shareholders"); Harris, *supra* note 1, at 603–04.

[187]*See* ABA Final Report, *supra* note 51, at 58 (explaining that, because disclosure is allowed only to the extent necessary to protect the organization, in most circumstances disclosure would only be appropriate to "persons outside the organization who have authority and responsibility to take appropriate preventive action.").

[188]*See supra* notes 73–77 and accompanying text (regarding the argument that an attorney has a fiduciary duty to use loyal disclosure to protect the entity client). Harris argues that a lawyer's duty of loyalty to the entity requires disclosure to all shareholders or other owners of the entity who do not otherwise know about the illegal conduct of constituents, and in the case of

address the illegality and prevents them from later arguing the attorney improperly failed to protect the company.[189]

In some circumstances, the act of disclosing information to an owner may itself remedy the threatened illegal conduct.[190] In others, disclosure to owners is simply a means of giving them the information that allows them to demand corrective action from those who control the organization. In the *Time Warner Entertainment*-based hypothetical case, loyal disclosure to an owner would have served this purpose. Recall that the theoretical attorney's client was a limited partnership, Six Flags Over Georgia, owned by one general partner and one limited partner.[191] I concluded that Six Flags Over Georgia's attorney was capable of determining that the general partner was in breach of its fiduciary duty by withholding profits from the Coca-Cola contract.[192] Extending the hypothetical case, the limited partnership's lawyer should take his or her concerns about the illegal conduct to the highest authority in the limited partnership,

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an insolvent organization, the lawyer's duty of loyalty "may include disclosure outside of the organization to third-party victims or government regulators." Harris, *supra* note 1, at 603–04. Professor Harris reasons that an attorney who does not disclose to owners of a solvent entity (or owners and/or third parties when necessary to protect the creditors of an insolvent entity) could be liable for failure to prevent harm by loyal disclosure. *Id.* at 604. He also would caution that, to avoid liability, disclosure should be made to all owners of a solvent organization or to owners and/or third parties capable of protecting the creditors of an insolvent entity if doing so is necessary to protect the entity. *Id.* at 643 & 646 ("The lawyer could thus avoid liability by making appropriate constituent disclosure in the case of a solvent client and by making appropriate third party disclosure in the case of an insolvent client.").

[189]Professor Harris explains that the wrongdoing of constituents would not be imputed to the organization for purposes of estoppel in a suit against the organization's attorney unless "all affected constituents of the organization not complicit in the wrongdoing have been informed of the wrongdoing." *Id.* at 604.

[190]One case provides a factual scenario in which loyal disclosure to an owner could have been used to prevent client wrongdoing. SEC v. Nat'l Student Mkg. Corp., 457 F. Supp. 682 (D.D.C. 1978). There, the court held that Interstate National Corporation's attorneys aided and abetted violation of antifraud provisions of federal securities laws by failing to take steps to ensure that the board provided corrected information to the company's shareholders. *Id.* at 713. If Model Rule 1.13 had been in place, even if the attorneys had been unsuccessful in persuading the board that corrected information should be provided, the Interstate attorneys (upon determining that the conduct was "clearly a violation of law") could have disclosed the corrected information to the shareholders, thus preventing the board from committing a fraud (and themselves from aiding and abetting that fraud).

[191]*See supra* notes 161–63 (discussing the identity of the limited partnership and its owners).

[192]*See supra* notes 170–72 and accompanying text.

presumably the board of directors of the corporation serving as general partner.[193] If and when the attorney's demand was ignored, the attorney should have considered whether disclosure to the limited partner, as the nonmanagement owner of Six Flags Over Georgia, could protect the client from the general partner's illegal conduct.[194] With a loyal disclosure rule in place, this attorney can reveal the terms of the contract and the amount of money being withheld from the limited partnership, giving the limited partner the information it needs to confront the general partner and demand the Coca-Cola funds for the limited partnership.[195]

When an owner's demand for corrective action is ignored, owners can file suit against the defalcating constituents, either on their own behalf or on behalf of the entity.[196] Under the federal civil procedure rules and equivalent state rules, a derivative action may be filed by owners of a corporation or any unincorporated association on behalf of the organization.[197] In the derivative suit, the owners may enforce the rights of the entity when the management has failed to do so.[198] An owner's demand for action, as a prerequisite to a possible derivative suit,[199] may be taken more seriously than the attorney's reporting up, because the entity's board

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[193]*See supra* note 162 (describing the general partner and its affiliated entities).

[194]*See infra* notes 231–33 and accompanying text (discussing that an attorney should request owner contact information from the client constituents).

[195]In the actual case, a representative of the limited partner did not learn that the exclusive beverage rights had been sold until four years after the transaction; when he asked to see the Coca-Cola agreement, his request was refused on the basis that the agreement was confidential. *Time Warner I*, 537 S.E.2d at 403. Continuing the hypothetical case, loyal disclosure of the Coca-Cola contract may have had the added incidental benefit of causing the limited partner to investigate and question other conduct of the general partner, perhaps preventing at least some portion of the $197,296,000 in damages it suffered at the hands of the general partner. *Time Warner II*, 563 S.E.2d at 180 n.1. *See also supra* notes 84–85 (discussing benefits to the entity client of disclosing ongoing illegal conduct sooner rather than later).

[196]Revelation of information to the individual or individuals who are capable of bringing suit by derivative action is consistent with the view followed by some courts that once a derivative suit is brought, the shareholders may be entitled to receive confidential and privileged information when they show "good cause." One indicator of good cause is whether the conduct alleged is "criminal, or illegal but not criminal, or of doubtful legality." Garner v. Wolfinbarger, 430 F.2d 1093, 1103–04 (5th Cir. 1970).

[197]FED. R. CIV. P. 23.1.

[198]*Id.*

[199]*Id.*

or other governing authority will recognize the threat of suit if the illegal conduct is not addressed. Attorneys should not resist reporting confidential information to owners for fear of a derivative suit.[200] When a derivative suit is used to stop illegal activity before it happens or to stop a continuing violation of law to protect the entity, a derivative suit clearly serves the entity's interest.[201]

Loyal disclosure is only permitted "to the extent" necessary to protect the entity client.[202] This admonition encourages an approach, at least initially, of limited disclosure. However, if that limited disclosure is not sufficient to protect the entity from serious illegal conduct, broader disclosure would be "the extent" of disclosure necessary to protect the entity.[203] From a practical perspective, whom should the attorney faced with the need for broader loyal disclosure inform? The possibilities are numerous because they are driven by the nature of the client entity, as well as the number and identity of the owners. In the case of a business with a small number of owners, whether organized as a corporation, limited liability company, or otherwise, an attorney may determine that it is reasonably necessary and practically possible to disclose to all of the nonmanagerial owners. In the case of a large corporation, the lawyer might determine that protecting the entity is most likely to be accomplished by first informing a majority shareholder of the illegal conduct, but then taking additional steps if the majority shareholder takes no action to protect the entity.[204]

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[200]Attorneys' skeptical view of derivative suits is consistent with ethics rules that allow corporate counsel to represent the managers in such a suit on the theory that the derivative suit is "nominally" in the name of the organization, "but usually is, in fact, a legal controversy over management of the organization." MODEL RULES R. 1.13 cmt. 13 (2003).

[201]This approach is consistent with Model Rule 1.13's additional comment that, when the derivative suit involves "serious charges of wrongdoing by those in control of the organization," a conflict may arise between the lawyer's duty to the organization and relation to the board. MODEL RULES R. 1.13 cmt. 14 (2003).

[202]MODEL RULES R. 1.13(c)(2) (2003) ("[T]he lawyer may reveal information relating to the representation ... but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."). Recall that the SEC rule is not applicable to owner disclosure, because it only provides the option of disclosing to the SEC. 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006).

[203]*See supra* notes 188–89 (discussing the extent of disclosure necessary to protect the solvent and the insolvent entity client).

[204]*See* Gillers, *supra* note 27, at 307 (suggesting that informing a majority shareholder may be sufficient.); Harris, *supra* note 1, at 647 (in proposing a loyal disclosure rule prior to the

2. Loyal Disclosure to Nonowners

Both loyal disclosure rules permit disclosure to nonowners. The SEC rule permits disclosure only to the SEC; the ABA rule permits disclosure to anyone capable of protecting the entity.[205] In some circumstances disclosure to nonowners is the only available option or is more likely to further the goal of protecting the entity.

Owner disclosure is not an available option in jurisdictions that have not adopted the 2003 version of Model Rule 1.13(c) or a similar rule.[206] Nonetheless, if the attorney's client is an "issuer," the attorney has the option of disclosure to the SEC under the SEC rule.[207] Further, disclosure to owners may not be practical when a company has numerous owners, when company ownership is subject to constant change, or when it is impossible to identify the owners of the company.[208] In situations where owner disclosure is impractical or cannot be accomplished, disclosure to a nonowner does not go further than "the extent reasonably necessary," as long as it protects the client from illegal conduct of constituents.[209] While there may be greater risks involved in making nonowner disclosure, it is called for under the loyal disclosure rules if it is limited to the extent necessary to protect the client.

Loyal disclosure to a nonowner that prevents an illegal transaction can accomplish the dual goals of protecting the client from illegality and minimizing other risks to the client. In fact, nonowner disclosure may be

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current ABA and SEC rules being adopted, Professor Harris explained that, under such a rule, disclosure might first be made to a shareholder with a "controlling block of stock."). Professor Gillers uses a 1982 fraud case as an example of how a majority shareholder could have been informed of the fraud of two directors on third parties, had there been a loyal disclosure rule. *Id.* at 306–07 (citing Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982), *cert. denied*, 459 U.S. 880 (1982)).

[205] 17 C.F.R. § 205.3(d)(2)(i) (2006); Model Rules R. 1.13(c) (2003). Under the SEC rule, disclosure is also allowed to the extent necessary to rectify the consequences of past illegal conduct. 17 C.F.R. § 205.3(d)(2)(iii) (2006).

[206] *See supra* note 62 and accompanying text (listing states that have adopted a loyal disclosure rule).

[207] 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006).

[208] *See infra* notes 231–33 and accompanying text (discussing involving client constituents in identifying owners and having a plan for disclosure to nonowners if identification is not provided).

[209] 17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006); Model Rules R. 1.13(c) (2003).

more expedient than owner disclosure and thus may be the best means of protecting the client. For example, a potential victim of a client's illegal conduct could be a recipient of confidential information that will prevent the consummation of the illegal act. This victim could be a purchaser of the client's business, a prospective investor in the client's company, a client vendor, or a client customer.[210]

Disclosure to a governmental body can also protect a client from prospective illegal conduct. This is the scenario envisioned by the SEC rule —disclosure to the SEC to prevent the client from committing a material violation[211]—and is also a valid option under the ABA rule.[212] Recalling the *Balla v. Gambro* case, disclosure to the FDA was an appropriate means of addressing the client's plan to sell dialyzers that violated FDA regulations; the FDA was in a position to seize the dialyzers before they were sold.[213] Such disclosure would also be appropriate when the illegal act is a client's plan to provide a government agency with false information. The attorney's disclosure of correct information to the agency may prevent or ameliorate the illegal act.[214]

When the client conduct at issue is ongoing (under either the SEC or ABA rule) or happened in the past (under the SEC rule permitting disclosure to rectify the consequences of a material violation), disclosure to a nonowner raises the added concern that it will result in liability for past conduct. But the potential risks of such a disclosure do not necessarily make it inappropriate.[215] When assessing the risks of disclosure, the attorney should focus on how to limit it to an extent no greater than necessary to protect the client.[216] When considering disclosure to a

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[210]*Cf. supra* note 190 (discussing a hypothetical situation concerning how disclosure can prevent client wrongdoing in the context of owner disclosure).

[211]17 C.F.R. § 205.3(d)(2)(i) (2006).

[212]MODEL RULES R. 1.13(c) (2003).

[213]*Balla*, 584 N.E.2d at 105–06.

[214]*See* John C. Coffee, *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1298 (2003) ("Attorneys . . . are often in a position to block or delay transactions or governmental approvals that are vital to their corporate clients. This is truest in the case of securities attorneys, who could potentially block the effectiveness of a registration statement or the consummation of a merger simply by signaling their displeasure to the SEC.").

[215]*See supra* notes 84–85 and accompanying text.

[216]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006); MODEL RULES R. 1.13(c) (2003).

government agency, the attorney should contemplate what agreements might be made with the agency to protect the client.[217] Other considerations may include whether the agency has adopted a policy of leniency toward an entity that self-reports its wrongdoing[218] and the impact of the attorney's disclosure on sentencing.[219]

Selecting a recipient of loyal disclosure is difficult because the lawyer must both protect the client from illegal conduct and minimize the risk inherent in revealing the illegal conduct. Because there are significant advantages of disclosure to owners, attorneys should first consider whether disclosure to them is possible and appropriate. When owner disclosure is not practical or is not the best way to protect the client, attorneys should

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[217]*See* Gillers, *supra* note 27, at 305 ("[T]he lawyer may have to approach a regulator, a prosecutor, or some other party. If so, the lawyer may be able to negotiate for confidentiality. This may be accomplished by making the initial contact through another lawyer who will keep the first attorney's identity (and the client's name) secret until the details of the cooperation are established.").

[218]A Department of Justice policy adopted January 20, 2003 states that, in making charging decisions, the Department of Justice will consider the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents. *See* ABA Presidential Task Force on the Attorney–Client Privilege Report, *available at* http://www.abanet.org/buslaw/attorneyclient/materials/hod/report.pdf, at 14 (citing Memorandum from Deputy Attorney General Larry Thompson to Heads of Department Components and U.S. Attorneys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003)). In light of this policy, a lawyer might consider whether his or her disclosure of constituent wrongdoing might assist the true client in avoiding prosecution. *See also id.* at 1046–47 n.78–80 and accompanying text, referencing cooperation and disclosure programs and policies adopted by the Department of Justice Antitrust Division, the Environmental Protection Agency, Health and Human Services, and the Securities and Exchange Commission. Whether counsel's unilaterally disclosing information under these circumstances would entitle the company to leniency is a question it would be incumbent upon the attorney to answer prior to making disclosure.

[219]*See* U.S. Sentencing Guidelines Manual, § 8C2.5(g) (subtracting points from an organization's culpability score for self-reporting, cooperation, and acceptance of responsibility) (Nov. 2006) [hereinafter U.S.S.G.]. Whether this subtraction would be given for an attorney's unilateral disclosure is unclear and would likely turn on the facts of the case. *See* U.S.S.G., § 8C2.5, cmt. 13 (explaining how a determination is made regarding the "organization's cooperation"). Sentencing guidelines also penalize organizations whose highest level employees do not respond appropriately to illegal conduct; because such an inappropriate response is a prerequisite to loyal disclosure, this may impact the sentence. *See* U.S.S.G. § § 8C2.5(b) (adding points to an organization's culpability score when high-level personnel "participated in, condoned, or was willfully ignorant of the offense") & § 8C2.5(f) (not allowing a subtraction of points for an effective compliance and ethics program when high-level personnel "participated in, condoned or was willfully ignorant of the offense.").

give thoughtful consideration to disclosure to a third party. In either case, a large task still remains in executing the loyal disclosure.

IV. A Plan for Executing Loyal Disclosure

When the attorney has decided that disclosure is appropriate, the remaining challenge is a practical one: execution. This is not as simple as disclosing the information. An attorney must prepare the content of the disclosure carefully, think about seeking a second opinion, consider informing client constituents, obtain owner information where called for and, in some cases, prepare an alternate plan for disclosure. This final section considers each of these issues.

Preparing a letter to the intended recipients of loyal disclosure is an important first step. In fact, the letter will be useful for purposes beyond the actual disclosure. Drafting such a letter requires the attorney to organize the relevant facts and any relevant documents, to articulate the legal standards that are applicable, and to explain not only the attorney's analysis that led to a conclusion of illegality but also the selection of the loyal disclosure recipient or recipients.[220] The process of preparing the letter may reveal holes in the analysis, which may lead to additional investigation or research and a better decision about the appropriateness of disclosure. When and if the letter is ultimately delivered, it will give its recipients a clear understanding of the illegal conduct, enabling an informed decision about how to proceed. Further, if there are ever questions, litigation, or disciplinary action concerning the disclosure, the letter will provide the best evidence of the content of the disclosure and the attorney's reasoning. But even before disclosure is made, the attorney should consider two other uses for the letter: providing it to a disinterested attorney and to the client constituents.

Seeking a second opinion is another significant step to consider in executing a plan of disclosure. An attorney contemplating loyal disclosure

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[220]Because loyal disclosure is only appropriate "to the extent" necessary to protect the client, there are some cases when the recipient may not need to know all of the facts and analysis, or even the conclusion that the client is doing something illegal. This may be the case, for example, when the disclosure of certain information itself will prevent a fraud. *See supra* notes 190 & 210 and accompanying text. Even in that scenario, the attorney would still be wise to articulate his or her analysis in writing to be used for the other purposes discussed in this section.

should understand the risks of his or her decision: inappropriately disclosing client confidences violates ethics rules and the duty of loyalty,[221] while remaining silent when disclosure would have protected the client will be to the client's peril and may breach the attorney's duties of loyalty and care to the client.[222] Faced with this dilemma, an attorney would be wise to turn to a disinterested attorney who could analyze whether disclosure is appropriate.[223] Model Rule 1.6 permits an attorney to disclose confidential information in order to obtain legal advice regarding his or her compliance with ethics rules.[224] The lawyer seeking the opinion should provide the disinterested attorney with all of the relevant facts and supporting documents. If the lawyer seeking advice has already prepared a draft of the intended disclosure, the disinterested attorney is an ideal person to review the letter. The disinterested attorney should undertake an independent analysis to determine if the conduct at issue is illegal and to whom disclosure should be made. Ideally, the disinterested attorney also would employ many of the tools suggested in this article.

Attorneys planning for loyal disclosure should also consider the advantages, and perhaps the necessity, of communicating the plan to client constituents. The SEC and ABA reporting-up rules require the attorney to discuss illegal conduct with the highest authority of the entity.[225] This reporting-up conversation is the ideal time for the attorney to inform the company's highest authority that, if an acceptable response is not received

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[221]*See supra* note 9 and accompanying text (explaining the ethical duty to keep the client's confidences); *supra* note 18 (discussing the fiduciary duty of loyalty, which requires the attorney to keep the client's confidences).

[222]*See supra* notes 73–77 and accompanying text (discussing an attorney's fiduciary duty to use loyal disclosure to protect the entity client).

[223]For example, Texas' Organization As Client rule contains a comment encouraging attorneys to seek an independent legal opinion when they are unsure of their obligations under the rule. TEX. ST. R.P.C. R. 1.12 cmt. 6 ("At some point it may be useful or essential to obtain an independent legal opinion.")

[224]MODEL RULES R. 1.6(b)(4) (2003) (allowing disclosure to the extent the lawyer reasonably believes necessary "to secure legal advice about the lawyer's compliance with these Rules.").

[225]17 C.F.R. § 205.3(b)(1), (3), & (4) (2006); 17 C.F.R. § 205.3(c) (2006) (requiring an attorney to report up "evidence of a material violation"); 17 C.F.R. § 205.3(b)(9) (2006) (requiring the attorney to inform executives if the attorney is not satisfied with their response); MODEL RULES R. 1.13(c)(1) (2003) (permitting loyal disclosure after reporting up has failed, that is, the highest authority capable of acting either insists upon or fails to timely and appropriately address a clear violation of law).

within a stated time period, he or she plans to disclose the illegal conduct under loyal disclosure rules.[226] The attorney should explain why loyal disclosure is appropriate to protect the entity and that the attorney, as a fiduciary, has an obligation to make such disclosure.[227] Providing the draft disclosure letter at this time divulges the attorney's analysis and previews the consequences of not heeding the attorney's advice to correct the conduct.

The ABA has noted that the threat of disclosure may be a tool used to encourage clients to act legally,[228] and this may be the result of communicating a loyal disclosure plan with constituents. While some attorneys may be concerned that previewing loyal disclosure will result in their being discharged immediately and the necessary disclosure thereby being thwarted, the rules do not prohibit an attorney from making loyal disclosure after his or her discharge.[229] Another consequence of forewarning the client of upcoming loyal disclosure may be that the client will retain separate counsel and seek a court order prohibiting the attorney from disclosing the information. While the prospect of litigation may not be attractive, it will allow the attorney to present the facts and reasoning to a neutral third party, who then will determine if disclosure is appropriate under applicable rules.

For attorneys considering disclosure to owners, some will face the practical problem that they do not know the identity of or have access to

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[226]Ohio recommends such an approach when it would advance the purpose of disclosure. *See* OHIO RULES PROF'L CONDUCT R. 1.13, cmt. 6 ("The lawyer should consider whether giving notice to a higher authority within the organization of the lawyer's intent to disclose confidential information ... would advance or interfere with the purpose of the disclosure."). Discussing a loyal disclosure plan at this meeting requires that the attorney think one step ahead; at the time that the attorney considers whether reporting up is required, the attorney should also consider whether he or she can conclude that the subject conduct is a "material violation" and/or "clearly a violation of law" such that loyal disclosure is also appropriate.

[227]*See supra* notes 73–77 and accompanying text (discussing fiduciary duty to make loyal disclosure).

[228]ABA Final Report, *supra* note 51, at 55 (in discussing objections to expanding confidentiality exceptions under Model Rule 1.6, the Task Force noted that even if disclosure is "rarely if ever employed" the existence of the authority to disclose "gives lawyers the opportunity to use that power to encourage the client to remediate or refrain from unlawful conduct.").

[229]MODEL RULES R. 1.13 (2003); 17 C.F.R. § 205 (2006). *See also* MODEL RULES R. 1.13(e) (requiring an attorney who is discharged for reporting up the ladder or for making loyal disclosure to inform the highest authority in the organization).

contact information for owners. For companies with registered securities, the SEC does not maintain lists of shareholders or their contact information.[230] For other organizational clients, all of which are covered by Model Rule 1.13(c), the publicly available information normally does not include the identity of and contact information for owners. Another advantage of communicating a loyal disclosure plan to the client constituents is that the attorney can request owner contact information at that time. The attorney should ask the client constituents with whom he or she is dealing to provide a list of owners, including addresses as of the date of the communication, and should give the client constituent a deadline for providing the owner list.[231] Because clients may resist or ignore this request, attorneys must also think about the next topic, having an alternate disclosure plan.

An alternate disclosure plan is necessary because the original plan may not work. Again, disclosure is appropriate under the ABA and SEC loyal disclosure rules "to the extent reasonably necessary" to protect the client.[232] When one plan fails, the extent of disclosure necessary to protect the client may extend to include new disclosure recipients.[233] An alternate plan is especially necessary when constituent cooperation is required for the attorney to learn owner contact information. In that context, even if owner disclosure is preferable, lack of client cooperation may mean disclosure to a third party is the disclosure that is necessary. Without such an alternate plan, disclosure may be easily thwarted by client constituents. Explaining the alternative disclosure plan—the one that will be resorted to if their cooperation is not forthcoming—will demonstrate to client constituents that the attorney is not just making an empty promise. This may

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[230]U.S. Securities and Exchange Commission Answers to Frequently Asked Questions, "Shareholder's Lists, When You Can Get Them," *available at* http://www.sec.gov/answers/sharehlist.htm (last viewed Apr. 5, 2007).

[231]The lawyer who knows owner information could alternatively tell the client the loyal disclosure plan and tell the client to which owner or owners the information will be communicated if action is not taken to address the illegal conduct.

[232]17 C.F.R. § 205.3(d)(2)(i) & (iii) (2006); MODEL RULES R. 1.13(c) (2003). *See also supra* note 87 (highlighting the language of the rules concerning this issue).

[233]*See supra* notes 188–89 (citing Professor Harris's argument regarding the full extent of disclosure that is necessary), 202–04 and accompanying text (discussing an approach of limited owner disclosure, and then if needed, additional disclosure), & 208–09 and accompanying text (discussing expanding disclosure to nonowners when the attorney is not able to identify owners).

provide further incentive for constituents to correct the illegal conduct or, at the very least, to provide the requested owner contact information.

Ultimately, a well-thought-out disclosure plan may obviate the need for disclosure altogether, for example, where client constituents faced with disclosure choose to avoid or correct illegal conduct. In that scenario, the purpose of the rules is accomplished without the need for disclosure. But even in the cases where disclosure does occur, it is in the attorney's interest to devote time to properly planning for disclosure. Such forethought leads to the attorney providing recipients with the information needed to protect the entity client and may protect the lawyer from liability as well.

V. Conclusion

When attorneys overcome the barriers to loyal disclosure discussed in this article, they will critically analyze the appropriateness of loyal disclosure. Lawyers who previously may have misunderstood the purpose of loyal disclosure or misconstrued the text of the rules now should have a new perspective on their obligations as advisors and fiduciaries, as well as the tools they need to determine whether disclosure will protect their entity clients.

Disclosure will not always be the result of an appropriate analysis. In fact, in discussing how an attorney should evaluate the disclosure question, this article reveals that the rules have inherent limits that are not, and should not be, overcome by the tools for analysis suggested here. This new framework is not intended to alter or extend the application of the loyal disclosure rules, but to help attorneys appropriately analyze the issue of loyal disclosure within the limits set by the rules.

Even with the advent of these loyal disclosure rules and the use of the analytical model suggested here, might attorneys be able to prevent the next Enron? The answer appears to be only "maybe." The SEC, ABA, and state bars should not mislead the public or themselves about what attorneys can accomplish with these rules. While both the SEC and ABA have billed their new attorney ethics rules as tools for promoting corporate responsibility,[234] in practice they require lawyers to have a high level of certainty that client constituent conduct is illegal before they can disclose it.

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[234]*See supra* notes 43–46, 60, & 112 and accompanying text.

Because business misconduct is often factually and legally complex, it will be difficult—but not always impossible—for attorneys to meet this high standard. An attorney using this new construct may, however, be capable of isolating and reporting a clear instance of illegal conduct located in a sea of possible illegality. In that scenario, it is possible for an attorney to use loyal disclosure to protect the entity client as envisioned by the loyal disclosure rules.